

AD-A096 305

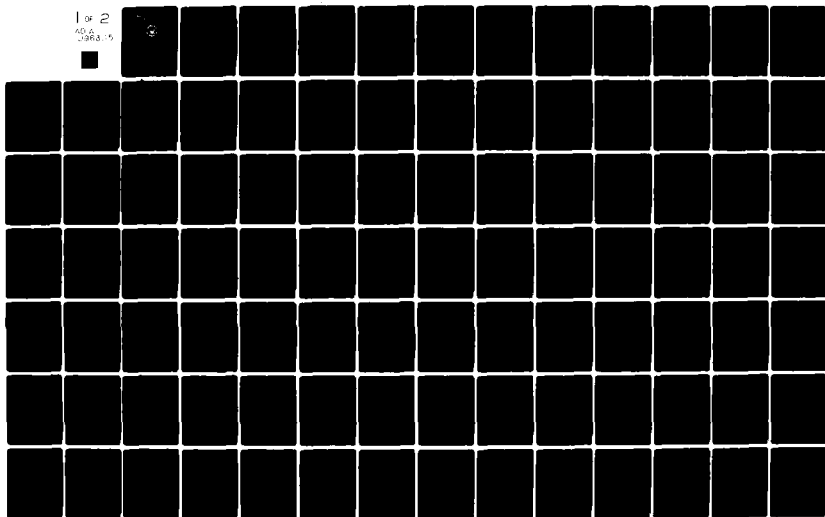
NAVAL POSTGRADUATE SCHOOL MONTEREY CA
DOD PROFIT POLICY. ITS EFFECTIVENESS. THE CONTRACTING OFFICER'S--ETC(U)
DEC 80 T P ANDERSON

F/G 5/1

UNCLASSIFIED

NL

1 of 2
NO. 1
1983.5



52

UNCLASSIFIED

2

NAVAL POSTGRADUATE SCHOOL

Monterey, California

AD A 096305



THESIS

DOD PROFIT POLICY
ITS EFFECTIVENESS--THE CONTRACTING
OFFICER'S VIEW

by

Thomas Perry Anderson, IV

December 1980

Thesis Advisor:

M. L. Sneiderman

Approved for public release; distribution unlimited

DBS FILE COPY

81 3 13 125

SECURITY CLASSIFICATION OF THIS PAGE (When Data Entered)

REPORT DOCUMENTATION PAGE		READ INSTRUCTIONS BEFORE COMPLETING FORM
1. REPORT NUMBER	2. GOVT ACCESSION NO. AD-A096305	3. RECIPIENT'S CATALOG NUMBER
4. TITLE (and Subtitle) DOD PROFIT POLICY. Its Effectiveness. The Contracting Officer's View.		5. TYPE OF REPORT & PERIOD COVERED Master's Thesis, December 1980
7. AUTHOR(s) 10 Thomas Perry/Anderson, IV		6. PERFORMING ORG. REPORT NUMBER
9. PERFORMING ORGANIZATION NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		8. CONTRACT OR GRANT NUMBER(s)
11. CONTROLLING OFFICE NAME AND ADDRESS Naval Postgraduate School Monterey, California 93940		12. REPORT DATE 11 December 1980
14. MONITORING AGENCY NAME & ADDRESS (if different from Controlling Office) Naval Postgraduate School Monterey, California 93940		13. NUMBER OF PAGES 100
		15. SECURITY CLASS. (of this report) Unclassified
		15a. DECLASSIFICATION/DOWNGRADING SCHEDULE
16. DISTRIBUTION STATEMENT (of this Report) Approved for public release; distribution unlimited		
17. DISTRIBUTION STATEMENT (of the abstract entered in Block 20, if different from Report)		
18. SUPPLEMENTARY NOTES		
19. KEY WORDS (Continue on reverse side if necessary and identify by block number)		
20. ABSTRACT (Continue on reverse side if necessary and identify by block number) The purpose of this thesis was to seek out the opinion of the Procurement Contracting Officers within the Department of Defense as to their perceptions of the effectiveness of DOD's Profit Policy. This was accomplished by means of a questionnaire sent to PCO's at 25 major buying commands within DOD. The results of the survey showed that PCO's felt that (1) profit policy was ineffective in incentivizing contractor investment; (2) facilities		

DD FORM 1473
1 JAN 73

EDITION OF 1 NOV 68 IS OBSOLETE
S/N 0102-014-6601

SECURITY CLASSIFICATION OF THIS PAGE (When Data Entered)

capital and the productivity reward were having little or no effect on contractor investment; (3) program instability and the impact of socio-economic programs on the contracting process were major contributors to profit policy's ineffectiveness; (4) DOD Profit Policy did not have a high priority in their organizations.

Recommendations are made concerning methods for improving profit policy and for additional study.

Approved for public release; distribution unlimited

DOD PROFIT POLICY
Its Effectiveness--The Contracting Officer's View

by

Thomas Perry Anderson, IV
Lieutenant, Supply Corps, United States Navy
B.S., University of Missouri, 1974

Submitted in partial fulfillment of the
requirements for the degree of

MASTER OF SCIENCE IN MANAGEMENT

from the

NAVAL POSTGRADUATE SCHOOL
December 1980

Author:

Thomas Perry Anderson, IV

Approved by:

Mr. S. J. Friedman

Thesis Advisor

Berlin Kalypso

Second Reader

Chairman, Department of Administrative Sciences

W. M. Wood

Dean of Information and Policy Sciences

ABSTRACT

The purpose of this thesis was to seek out the opinion of the Procurement Contracting Officers within the Department of Defense as to their perceptions of the effectiveness of DOD's Profit Policy. This was accomplished by means of a questionnaire sent to PCO's at 25 major buying commands within DOD. The results of the survey showed that PCO's felt that (1) profit policy was ineffective in incentivizing contractor investment; (2) facilities capital and the productivity reward were having little or no effect on contractor investment; (3) program instability and the impact of socio-economic programs on the contracting process were major contributors to profit policy's ineffectiveness; (4) DOD Profit Policy did not have a high priority in their organizations.

Recommendations are made concerning methods for improving profit policy and for additional study.

TABLE OF CONTENTS

I.	INTRODUCTION -----	8
A.	OBJECTIVES OF THE RESEARCH -----	8
B.	RESEARCH QUESTION -----	9
C.	SCOPE, LIMITATIONS, AND ASSUMPTIONS -----	9
D.	RESEARCH METHODOLOGY -----	11
E.	ORGANIZATION OF THE STUDY -----	11
II.	FRAMEWORK -----	12
A.	INTRODUCTION -----	12
B.	IMPORTANT ENVIRONMENTAL FACTORS -----	12
C.	DEFENSE MARKET -----	22
D.	SUMMARY -----	26
III.	DOD PROFIT POLICY -----	27
A.	DEVELOPMENT -----	27
B.	CURRENT POLICY -----	37
C.	CONTINUING PROBLEMS -----	43
D.	SUMMARY -----	45
IV.	PRESENTATION OF THE SURVEY DATA -----	46
A.	INTRODUCTION -----	46
B.	SURVEY BACKGROUND -----	46
C.	SURVEY RESPONSES -----	48
	1. Demographic Data -----	48
	2. Guidance -----	52
	3. Organizational Emphasis -----	54

4. Policy Mechanics and Operations -----	57
5. Interaction with Other Policies -----	63
6. Recommended Improvements -----	65
D. SUMMARY -----	66
V. PRINCIPAL FINDINGS, CONCLUSIONS, AND RECOMMENDATIONS -----	68
A. FINDINGS AND CONCLUSIONS -----	68
B. RECOMMENDATIONS -----	70
APPENDIX A: PRESENT PROFIT POLICY AS STATED IN DAR 3-808 -----	72
APPENDIX B: COVER LETTER AND SURVEY QUESTIONNAIRE -----	89
APPENDIX C: LISTING OF ACTIVITIES RECEIVING QUESTIONNAIRE -----	94
LIST OF REFERENCES -----	96
INITIAL DISTRIBUTION LIST -----	100

LIST OF TABLES

I.	EDUCATIONAL ACHIEVEMENT LEVEL -----	49
II.	DISTRIBUTION AMONG CONTRACT VALUE GROUPS -----	50
III.	COMBINED DEMOGRAPHIC DATA -----	51
IV.	USEFULNESS OF DOD PROFIT POLICY GUIDANCE -----	52
V.	USEFULNESS OF PROFIT POLICY GUIDANCE BY CONTRACT VALUE GROUPS -----	53
VI.	SOURCES OF GUIDANCE -----	55
VII.	ORGANIZATIONAL POLICY PRIORITY -----	57
VIII.	IS PROFIT POLICY CAPABLE OF MOTIVATING CONTRACTOR INVESTMENT IN PLANT AND EQUIPMENT? ----	58
IX.	TABLE VIII RESPONSES BY CONTRACT VALUE GROUPS -----	58
X.	IS PROFIT POLICY THE PROPER TOOL TO ENCOURAGE CONTRACTOR INVESTMENT? -----	59
XI.	IS PROFIT POLICY THE PROPER TOOL TO ENCOURAGE CONTRACTOR INVESTMENT? (BY CONTRACT VALUE GROUPS) -----	60
XII.	HAS A CONTRACTOR CHANGED HIS CAPITAL EXPENDITURES BECAUSE OF PROFIT POLICY PROVISIONS? -----	62

I. INTRODUCTION

A. OBJECTIVES OF THE RESEARCH

Today the Department of Defense (DOD) is experiencing continuing growth in the cost of its major weapons systems and their required spare parts and support materials [16]. In an attempt to mitigate these increasing costs, DOD is using profit policy as a tool to incentivize defense contractors to invest in more productive plant and equipment, and more efficient production methods. Since its inception in 1963 present Profit Policy has been the subject of intense and continued research. Most of the research appears to focus on the theoretical and defense contractor points of view [21, 24, 44]. Very little appears to have been done in researching the profit policy from the point of view of Government contracting personnel. The purpose of this study is to take a segment of the Government contracting personnel, the Procurement Contracting Officers (PCO), and determine their opinions on the Profit Policy's effectiveness in accomplishing its objectives.

It is hoped that this study will help fill a small portion of the void in the research on profit policy. A more thorough understanding of the PCO's view of profit policy will hopefully provide to decision makers determining the future course of profit policy an extra added insight.

Additionally, the problems and strengths outlined by the PCO's should provide another perspective on ways to improve or increase profit policy's effectiveness.

B. RESEARCH QUESTION

Given the preceding general objectives, the following primary research question was posed: How do Department of Defense Procurement Contracting Officers view the effectiveness of DOD's Profit Policy?

The following ancilliary research questions are deemed pertinent in addressing the basic research question:

What is the present DOD Profit Policy?

What is its history and background?

What are its current problems?

C. SCOPE, LIMITATIONS, AND ASSUMPTIONS

This research effort is primarily concerned with the acquisition by DOD of weapon systems, spare parts and required support materials. Within this set the scope is narrowed to those situations where true price competition¹ does not exist and cost analysis is necessary to assure

¹True price competition can be defined by the following criteria:

- a. The specifications of the item or service to be purchased are explicitly clear to both buyer and seller.
- b. The market consists of an adequate number of sellers.
- c. The sellers comprising the market activity want the contract and are therefore willing to price competitively to get it.
- d. The time available is sufficient for using this method of purchasing. [42:178]

that the Government is receiving a fair price. It is within these confines that profit policy operates.

The study of DOD's Profit Policy is an extremely broad and complex subject. Interpretation of this policy can be effected by one's point of view. All those who are touched by the policy, the policy makers, the policy implementers, and the defense contractors, may view a particular problem in three totally different ways that may be equally valid. Also, the defense market consists of an extremely heterogeneous group of contractors who range from those heavily dependent on DOD contracts to those whose Government business is a small portion of their business. Additionally this range of contractors makes a diverse list of products--semi-conductors to ships. These complexities have a direct bearing on profit policy effectiveness but are beyond the limits of this research. This study focuses on a small segment of the policy implementers, the PCO's. It is hoped that by concentrating on this group, pertinent information will be generated for inclusion in the data base on profit policy.

This study assumes that the reader commands a general knowledge or familiarity with DOD contracting language, and the defense acquisition process. Additionally it is further assumed that the reader possesses a basic understanding of the role played by PCO's in the defense acquisition process.

D. RESEARCH METHODOLOGY

The research methodology utilized in this study consisted of two basic components: (1) development of a literature base, and (2) a survey of DOD PCO's. The literature base was mainly compiled through the Defense Logistics Studies Information Exchange, the Naval Postgraduate School Library, and a review of various journals and periodicals which concern themselves with Government acquisition. The questionnaire was sent to PCO's in the Departments of the Air Force, Army, Navy and in the Defense Logistics Agency. The data collected from the questionnaire are displayed in tables throughout the study. The questionnaire itself is included as Appendix B.

E. ORGANIZATION OF THE STUDY

This study attempts to take the reader through the subject at hand in the most logical manner possible. Chapter II is designed to give the reader a brief view of the defense market and the external factors that can have a bearing on it. A review of the defense market will hopefully provide an understanding of the environment in which profit policy seeks to operate. In Chapter Three the historical outline and development of the current policy will be chronologically traced. Additionally, current problems with the policy will be highlighted. This will present a background from which to review the results of the questionnaire as contained in Chapter IV. Chapter V will offer findings, conclusions and recommendations.

II. FRAMEWORK

A. INTRODUCTION

Before embarking on any meaningful discussion of DOD's Profit Policy and its effectiveness as viewed by DOD Procurement Contracting Officers, certain key concepts and information must be presented. First there are certain salient factors that are normally considered outside the realm of contracting officers that can have significant direct or indirect effects on profit policy and its effectiveness. Second, a review of the "Defense Market" will provide a close look at its characteristics in order to give sufficient background to review profit policy.

B. IMPORTANT ENVIRONMENTAL FACTORS

The acquisition of defense weaponry is a very complex process. It takes place in a fluid environment that contains factors that can have direct effects on defense procurement. It is important to understand and be aware of these factors for not only do they impact the acquisition process but contracting personnel by their decisions can influence or change these environmental factors.

Probably the most visible factor is the level of international tension. The decade of the 1970's provides a good example. Early in the decade as the Vietnam War wound down,

the U.S. and the Soviet Union began negotiating Strategic Arms Limitation Treaties and developing a policy of detente. This apparent lessening of tension brought a shift in the American view of Defense and therefore the acquisition of defense material. Congress and the American people became more interested in expanding social programs, improving the environment, etc. Why should there be increases in spending for military hardware if we are becoming more friendly with our enemies? This attitude had a definite impact by 1975 when the Defense Procurement Account was at its lowest point since the post World War II demobilization [17:63]. By the end of 1979 the level of world tension had changed. Americans had been taken hostage in Iran and the Soviets had occupied Afganistan. The impact of such a turn around becomes evident when reviewing the amount of money spent for military procurement in the last decade but especially FY79 to FY81 (Figure 1).

Another important factor in the defense acquisition environment is the political importance of DOD's procurement outlays. Depending on the swing of international tension and the perceived attitude of the American public, either we are spending too much and wasting our national resources or not enough is being spent to ensure adequate national security.

In comprehending this political sensitivity to defense and defense spending, it is important to understand why defense spending is so prominent in the political process

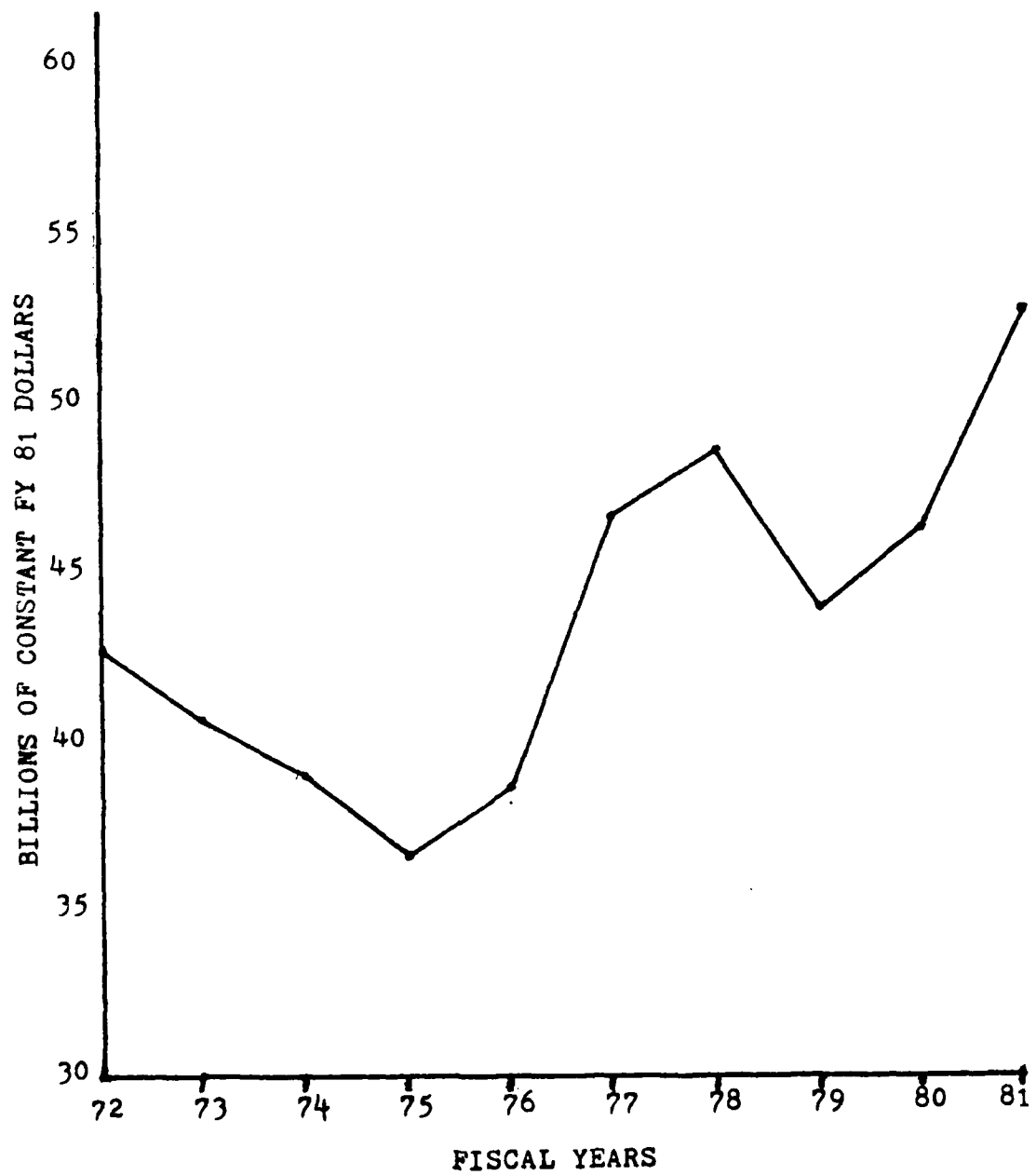


Figure 1. Trends in the Defense Procurement Budget

of this country. The amount of money spent in the defense acquisition arena and its perceived controllability commands attention. In FY 1981 the Defense Department plans to spend \$52.8 billion of its \$158 billion budget on buying weapons systems and their ancillary support items. The size and therefore the importance of the defense acquisition budget may not be so great when compared to the overall Federal Budget but this changes rapidly when one considers controllability. The controllability of the Federal Budget has been decreasing throughout the decade of the 70's (See Figure 2). [11:239]

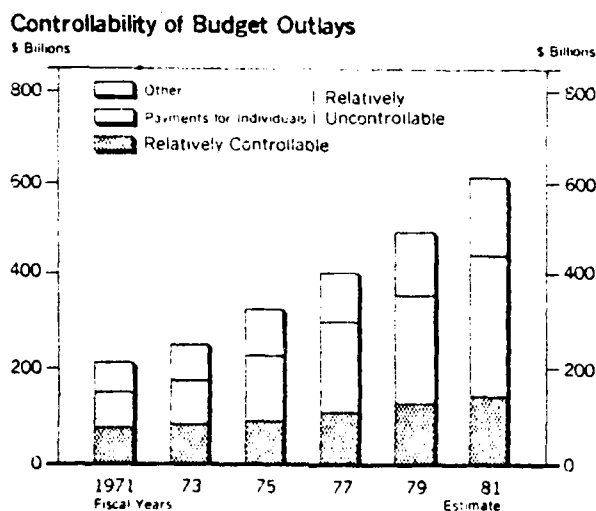


Figure 2.

In the FY 1981 budget proposal, the uncontrollables accounted for 76.6 per cent of all requested authorizations. Of the remaining 23.4 per cent, 61 per cent was made up of military spending [11:239]. This apparent controllability of

military spending is very important to the members of Congress. It is much easier and less emotional to argue the merits of and needs for an additional ship or more tanks or airplanes than to discuss the implications of curtailing a particular social program. Politically it is unpalatable to discuss starving or uneducated children or senior Americans freezing during the winter.

The uncertainty and complexity of the defense of this country make it hard for anyone to accurately foretell the impact of any changes made in spending for defense weaponry. The long time required to develop and buy any weapons system also puts the possible consequences out into the future seven to ten years. This allows a politician plenty of time to adjust his position. The amount of money spent and its controllability, and the relative ease in discussing the issues make the defense budget, especially the weapons procurement portion, a very attractive candidate for political manipulation and intrigue.

A new and unique characteristic of the defense acquisition environment is the equal funding of "guns and butter." Throughout the history of our country involvement in a conflict or war has meant that all the energies of the nation were channeled toward winning the war. Good examples of this would be the Civil War, and World Wars I and II. With the coming of the Korean conflict the ground rules seemed to change. Instead of being declared a war, it was

maintained as a police action and therefore did not qualify for total mobilization. In fact its impact on the civilian sector was minimal and rationing was not employed [17:64].

According to Mr. J. S. Gansler:

War was not to interfere with the civil section, unless it was to be "WWIII." The question of guns or butter was to be answered by "both". [17:64]

This idea of both "guns and butter" continues today.

The Vietnam War was carried on at the same time President Johnson was developing and implementing a plethora of expensive social programs. This apparent desire of the American government and people to pursue both social programs and high levels of military spending are very important when reviewing any portion of the defense acquisition environment. As weapons systems become more and more expensive (aircraft carrier--\$2 billion, aircraft--\$25 million) and as the cost of social programs continue to increase due to their indexing to the cost of living, the country may find that it can not afford both "guns and butter."

The nation's sensitivity to war profiteering is one of the constant parts of the defense acquisition environment. The idea of "Profiteering during war is a recurrent phenomenon that can be traced back to the earliest civilizations." [22:1] Indeed throughout the early history of the United States, there have been examples of both Government officials and industrial companies reaping undue gain from the nation's conflicts. During the Civil War, President Lincoln removed

his Secretary of War for various corrupt dealings with Government contractors. Also it is alleged that many of the nineteenth century capitalists (J. P. Morgan, Cornelius Vanderbilt and the du Ponts) made their first fortunes during the war from Government contracts [22:8]. Even though it appears that war profiteering has been of concern throughout history, World War I, the war to end all wars, generated war profiteering to end all war profiteering. The extent of the war profiteering came to light during the period between the two world wars. The attention to war profits generated such slogans as "Merchants of Death" and "Lets Take the Profits Out of War" and in 1934 resulted in the Senate creating a Special Committee on Investigations of the Munitions Industry [22:12].

The significance of this sensitivity to war profiteering is not whether there actually were excess profits made or that people were convicted of wrong doing, but that this sensitivity resulted in changes in the acquisition environment. From this era came legislation that is still being felt today--The Vinson Trammel Act of 1934--limits profits by statute and the creation of a renegotiations board to review the profits of defense contractors.

World War II brought a great many changes to the world --the atom bomb, destruction of colonial empires, the V-2 rocket, etc. According to Richard Kaufman, it:

...brought the end of what might be termed the classical era of war and peace, when wars had a beginning and an end and war profiteering rose and fell accordingly. The advent of the Cold War changed all that. The Federal Government has spent money for military purposes at wartime levels since 1951 and will continue to do so for the foreseeable future... [22:XV]

Though this characterization may be extreme or even inaccurate, it does point out that there has been a lot of change in the defense spending patterns. This continuing high level of spending has brought about many safeguards that inhibit excessive profits. The following is a list of some of these safeguards.

1. Truth in Negotiations Act with Defective Pricing Provisions (Public Law 87-653)
2. FAR Cost Principles Applicable to Fixed-Price Type Contracts (DAR 15-106)
3. Cost Accounting Standards (Public Law 91-379)
4. Weighted Guideline method of evaluating profit by Contracting Officers (DAR 3-808)
5. Strengthened procurement oversight organizations. (DCAA, GAO, DCAS)

The above mentioned safeguards notwithstanding, the fear of and distaste for "excessive" profits on defense contracts is still prevalent and held by people in very high positions. One of the more vituperative orations on war profiteering in recent history was delivered by Representative Henry B. Gonzales of Texas during the Congressional review of the need for a uniform cost accounting system. He is quoted as saying:

The profiteers who intentionally gouge the government for excessive profits during a time of war

are also guilty of consciously withdrawing efficiency from our industrial capacity. These private businessmen profiteers are in reality guilty of sabotage. Our history has been one of rampant war profiteering and I am convinced that even the limited annual reports of the Renegotiation Board reveal that profiteering is going on now, is increasing, and will continue to increase unless something more realistic is done to stop it. [43:130]

Another perennial critic of defense contractors and war profiteering is Senator William Proxmire who believed that "contractors (were) reaping huge hidden profits and that Pentagon procurement policies have institutionalized profiteering" [33:44]. Also during the Congressional fight over continuing the Renegotiations Board, President Carter favored continuing and strengthening the Board in order to "bear down hard on excessive profits in government contracts." [4:4].

It has become obvious that all parties involved in the acquisition of defense material should be responsive to both the electorate and elected officials distaste for excessive profits. If this distaste grows to be a national issue as it did in the period between the two world wars, it could manifest itself in the form of new rules, regulations, or laws that could have long term effects on the acquisition process, such as the Vinson Trammel Act which is still active today.

A final aspect of the acquisition environment that will become more important as the competition between "guns and butter" intensifies, is the acquisitions perceived efficiency.

Whether the process is efficient or not, is not the issue. The important topic is how the electorate and elected officials view the efficiency of the process. If the popular view of this issue becomes a national cause, it could very well end up producing long term changes in the acquisition process as did the anti-war profiteering fad between the two world wars.

A review of the literature shows that it is becoming an increasing concern of the public and is being studied by academicians. In a recent Gallop Newsweek Poll, 72 percent of the respondents felt that the money spent by DOD is spent inefficiently [28:50]. Such feelings will not be lost on Congressmen and should be sobering to those in the acquisition business. Also in his voluminous dissertation entitled The Diminishing Economic and Strategic Viability of the U.S. Defense Industrial Base, Jacques S. Gansler emphatically states and proves that:

...the resources of the defense industry, i.e., the "factors of production" (labor, capital, materials, etc.) are not being efficiently or effectively utilized. [17:1]

The preceding descriptions of the forces operating in the Defense Acquisition Environment were not meant to be all inclusive but to show that items often considered beyond the scope of acquisition can definitely effect it. Conversely it should not be lost on individual implementers of DOD policies that a very few individual actions or

contracts can have an impact on such forces in the acquisition environment. This becomes evident in reviewing findings of the Nye Committee which found that a few acts by individuals or corporations did result in excess profits [22:10-20]. Instead of prosecuting the violators, the result was that new statutes (Vinson-Trammell: Renegotiations Act) were enacted to cover all participants in the defense market. So it is vital for all personnel involved in buying weapons for DOD be aware of the environment in which they are working.

C. DEFENSE MARKET

In its efforts to ensure the Nation's security, the DOD spends billions of dollars to purchase needed systems and material--\$52.8 billion in FY 1981. This spending of such large sums of money for the Nation's defense creates a unique market situation. It is within this unique market that DOD's Profit Policy is implemented by Government contracting personnel.

Peck and Scherer stated that "a market system in its entirety can never exist for the acquisition of weapons [32:57]. While Gansler went one step farther and declared that:

The single major cause of the problems in the defense industrial base today is the false assumption that there is a "free market" in operation - when, in fact, one does not exist,... when policy makers on all sides of the military-industrial structure attempt "corrective"

actions based upon the assumption of the existence and operation of a free market. [17:105].

This unique market can be characterized by four basic criteria. A review of these criteria should provide a brief picture of the present defense market.

First, the DOD spends large sums of money in buying weapons and support items. DOD's procurement spending in real dollars between FY72 and FY81 increased almost 25 percent to \$52.8 billion. Even more important is the fact that the cost of defense weapons and related equipment is increasing at an annual rate of 5 percent (excluding inflation) [17:74]. Very few companies would have the financial capability to develop a major program by themselves. Compounding the cost of a program is the present volatile nature of the cost of money. With the prime rate fluctuating between 11 and 20 percent in a year's time, the cost of a major development program could be prohibitive. In order for the government to be able to purchase advanced weapons it must finance the development and production costs. By doing this, the U.S. Government has put itself in the role of investor and buyer, a position seldom if ever seen in a normal market [32:59].

Second, there are unique uncertainties inherent in the defense market. Private investments in major DOD acquisitions can be subjected to risks such as obsolescence, changed strategic plans, changed government policy,

unforeseen technical obstacles or changes, or funding changes. Examples of the impact of these risks on past programs are the Snark and Navaho missiles which were cancelled after the expenditure of \$700 million dollars on each. Their cancellations were mainly due to the ascendancy of the less vulnerable ballistic missile [32:47]. A more publicized example is the B-1 bomber, cancelled on 30 June 1977 only 7 months into Lot I production [24:33]. This change can be related to changes in funding, strategic and governmental policy.

In an attempt to mitigate the effects of these risks, the Government spreads the risks among all taxpayers by providing funds in the form of progress and advance payments. Additionally, termination liability and Government furnished plant and equipment are used to control a contractor's risk. Despite the attempts of government to reduce the amount of risk to which a defense contractor is exposed, the financial community feels that low profits and high risk are characteristics of the defense market that make it hard for defense industries to secure long and short term financing [37]. Though efforts have been made to reduce risk in the defense market, it would appear that the market still contains an abnormal amount of risk.

Striving to curtail risk in the defense market through the payment of Federal dollars, has lead the Government to inject the concepts of public trust and careful

expenditure of taxpayers dollars. To protect its interests in the acquisition process, the Government has added layers of:

...Federal statutes, regulations, executive orders, procuring agency directives, and judicial and administrative rulings and decisions designed to protect and to further Government acquisition interests and policies, safeguard the judicious expenditure of public funds, and help ensure the Federal Government receives the best possible products for its money [14:16].

This hands on approach by Government in the acquisition process may protect its interests but it surely adds another unique dimension to the defense market.

Finally the price for most weapons systems is not set in a fashion normally associated with a supply and demand market. The Government, being the only buyer in the defense acquisition process, and exerting the control it does, finds itself in the role of the sole buyer in a monopsony. Though the government is able to see competition in the early development of a program, once it selects a company to finish developing and produce the system, the Government then finds itself dealing with a monopolist. This relationship is further removed from normal market relationships by the lack of substitutes, and the feeling among contractors that they will fail if they don't have a major contract in house. This leads both parties into the situation where both sides feel they can not exist without the other. The pricing of weapons systems that evolves from this environment is not

at all related to the competitive market but rather to such artificial parameters as allowable costs, profit policy, and various other Government pronouncements [32:60].

D. SUMMARY

This chapter has attempted to portray forces in the acquisition environment and defense market in such a way that the reader gets a holistic view of them. It is intended that the complex nature of the acquisition world and the interactions of the various forces be perceived. It is within this complex universe that the Government strives to acquire the best possible weapons systems and support material. To help Government contracting personnel meet this goal, DOD has developed a profit policy applied to all negotiated contracts in an attempt to encourage efficient efforts by defense contractors. The development of this policy, its current position, and attendant problems will be outlined in Chapter III.

III. DOD PROFIT POLICY

A. DEVELOPMENT

Historically, purchasing by the Government has been on the basis of price competition and as such negated any need for a profit policy. It was felt that the competition in the market place among independent contractors would result in the Government receiving a fair and reasonable price. There were wartime aberrations in this basic philosophy which various bodies tried to deal with by means of excess profits taxes, mandates for competition, and profit limitation statutes. In spite of all the efforts to change or reform the acquisition process to avoid excess profits it remained based on the requirement for price competition with little specific guidance on how to handle situations where there was no true price competition.

During the Revolutionary War supplies and material were purchased using such vehicles as requisitions, commissions, and non-competitive contracts. In 1782 as a result of fraud, negligence, and waste of public property, Robert Morris, the Superintendent of Finance, directed that advertised competitive bidding be used in the purchasing of Government material [22:7]. Abuses continued and Congress continued to press harder for the pre-eminence of competitive bidding in the award of Government contracts. These efforts in the early

1800's finally culminated with the Civil Sundry Appropriation Act of 1861 which strongly stressed the need for competitive bidding. This Act (later called "Revised Statute 3709) with three major revisions remained the basic procurement statute until the Armed Services Procurement Act of 1947. This Act codified the many exceptions to the required competitive bidding on Government contracts. These exceptions had grown out of the need to buy a substantial amount of material in a short time to get the country ready for WWI and II.

The competitive bid process began to break down as the United States tried to mobilize the World War I. Competitive bidding contracts entailed a long and tedious process that did not lend itself to meeting the country's urgent need to get ready for war. As a result many unique military items were bought using negotiated cost plus a percentage of cost contracts (CPPC). In a CPPC contract, the profit or fee was determined by applying a fixed percentage to the costs incurred. Therefore if costs went up, profits went up, and if costs went down so did profits. This approach to contracting resulted in such abuses that during the period between the wars, Congress considered 200 bills and resolutions aimed at controlling war profits and improving the purchasing system. Due to differences between Congress and the Executive Branch no major improvements to the procurement system were brought forth [19:7].

The Government entered the mobilization for WWII with a "hodge podge" of directives, statutes and regulations that had been collecting on the books since the Civil War. But as the war got closer to America, Congress eased the requirements for competitive bidding and put a percentage ceiling on the fees that could be applied to cost reimbursement contracts. In implementing the First War Powers Act of 1941, the War Production Board, a group of industrialists and Government officials appointed by President Roosevelt to assure the most effective prosecution of war procurement and production, directed the abandonment of competitive bidding in favor of negotiating contracts. The procurement process became more concerned with the mobilization needs of delivery, quality and sources [8:522].

After the war, the Congress in an effort to consolidate the multitudinous statutes, regulations, etc., governing the DOD acquisition process into one manageable package passed the Armed Services Procurement Act of 1947. The Act and its implementing regulation, the Armed Services Procurement Regulations reaffirmed the dominance of competitive bidding but provided definite rules and guidance on how to handle negotiated contracts. Present day DOD Profit Policy had its beginnings in the first edition of ASPR. That early edition of ASPR stated that DOD must:

...apply contracting policies and methods designed to create an environment in which industry can realize profits on defense business which are high

enough to give reasonable assurance of long term availability to DOD industrial support by the best companies and to enable those defense contractors to attract sufficient equity and borrowed capital [29:3].

Even though ASPR brought structure to the DOD acquisition process, profit policy was still an unguided child.

During the 1950's, the Profit Policy outlined in ASPR developed into a narrative form that lacked specificity on the relationship between the elements to be considered when arriving at the appropriate profit level for a negotiated contract [25]. The varied nature of the nine profit policy factors made the contracting personnel's consideration of them a sizeable problem. (See Figure 3)

The Profit Policies inadequacies became highly visible in the early 60's. The Senate Committee on Government Operations, then known as the McClellan Committee, was investigating the Missile Procurement Program. The Committee found that prime contractors and their subcontractors were pyramiding profits and thus gaining unearned profits. The publicity from this investigation and other concurrent

- Effective competition
- Degree of risk
- Nature of work to be performed
- Extent of government assistance
- Extent of contractors investments
- Character of contractor's business
- Contractor performance
- Subcontracting
- Unrealistic estimates

Figure 3. Profit Policy Factors

studies done internally to DOD, resulted in the Logistics Management Institute (LMI) being tasked to study DOD's Profit Policy. The objective of the study was:

...to develop a rational, workable uniform and equitable approach to target profits which will result in a wider range of profits. The study aims to develop specific guidelines to assist contracting personnel in arriving at appropriate profit ratios to further national and departmental interests utilizing the profit motive of DOD contractors [25:1].

In reviewing DOD's Profit Policy and its implementation, LMI found that the predominant factor used by Government contracting personnel in determining profit or fee on a negotiated contract was "the profit or fee rate which had been established in earlier contracts with a specific service." [25:44] The contracting officers would then use the most advantageous of the nine profit factors listed in Figure 3 to adjust the base fee rate to appropriately reflect the procurement situation at hand. The importance of the integrity of the base fee rate was evident in one case reviewed by LMI. One contractor took a contract without any fee rather than accept a rate lower than his "historical rate" [25:44]. But not only did contractors have a strong tie to the historical fee or profit rate, the Government contracting personnel did also. This tendency was related to the necessity for any upward deviation from the historical rate to be completely justified. So an apparent desire to play it safe or not rock the boat lead to the use of the historical rate [25:49].

LMI also found that even though contractor investment is listed in ASPR as one of the nine profit factors to be used in determining fee or profit, it was not used. The lack of use was apparently based on the difficulty:

...in defining the term "investment", the difficulty in measuring the amount of investment involved and the tendency to compare one contractor with another contractor and hence work from averages [25:31].

Additionally LMI's study indicated that many procurement officials mentioned that a contractor's investment was often a criteria used in the source selection process and not by contracting officers negotiating fee or profit [25:31]. The plentiful number of contractors competing for defense contracts was taken as an indicator by LMI that there was not any problem in attracting capital to defense business. These findings and conclusions lead LMI to reject the idea of using contractor investment alone in determining profit or fee [25:59].

LMI considered a public utility approach, and an improved narrative format and rejected these along with the return on investment in favor of a Weighted Guidelines (WGL) approach. Figure 4 outlines the major elements of LMI's proposal. The WGL were an analytical method of implementing the profit factors listed in Figure 3. The desire to retain the current factors was due to their general acceptance by Government and industry and the perception that any substantial deviation from current principles would "require

- a. Contractor's Input to Total Performance
 - Direct Material
 - Purchased Parts
 - Subcontracted Items
 - Engineering Labor
 - Engineering Overhead
 - Manufacturing Labor
 - Manufacturing Overhead
 - General and Administrative Expense
- b. Contractor's Assumption of Contract Cost Risk
 - 1. Type, obligations, pricing provisions of contract
- c. Record of Contractor's Performance
 - 1. Management
 - 2. Cost Efficiency
 - 3. Reliability of Cost Estimates
 - 4. Timely Deliveries
 - 5. Quality of Product
 - 6. General Research
- d. Selected Factors
 - 1. Source of Resources
 - a. Government or Contractor Source of Financial, Material and Technical Resources
 - 2. Special Achievement, if any, Required in Contract
 - a. Technical or Other Achievement
 - 3. Other

Figure 4. LMI's Weighted Guideline Proposal

considerable liaison, education, and acceptance by others than the Department of Defense" [25:62].

LMI's recommendations were accepted by DOD and became a part of ASPR in August of 1963. Not six months after the introduction of the WGL, members of a Defense Industry Advisory Council Working Group on unallowable costs criticized the WGL for not adequately considering the financial resources used by contractors. In rebuttal of these charges, LMI published a report that concluded that the weight given to contractor investment was significant even if it was indirect and imprecise. The report went on and delineated four ways in which the WGL accounted for contractor investment:

1. The source of resource factors.
2. Different profit rates for in-house costs and the cost of purchased materials.
3. Profit rates applied to depreciation.
4. Profit rates applied to total costs (costs and investments tend to increase and decline together as demonstrated by a statistical study of aerospace companies) [21:7].

DOD renewed its interest in contractor investment when it directed LMI to conduct a survey on this subject. The results of this study contradicted their 1964 report on contractor investment under the weighted guidelines. In 1967 LMI found that the WGL had a negative incentive for contractors to invest. As contract prices went down so did profits. Conversely as costs went up so did profits. The study concluded that the WGL provided incentives for the

contractor not to invest in cost reducing plant and equipment but to allow costs to escalate. This ran counter to the fact that cost reducing efforts on defense contracts was in the Nation's best interest. LMI recommended that the WGL be expanded to allow profit objectives to be determined by cost and assets applied. The proposed solution went on to state that the assets to use in determining profit should be operating and facilities capital [31-110].

The theme of LMI's study was picked up and carried along by many others. In a 1971 study, GAO found that:

...by relating profits to costs, contractors in non-competitive situations are not provided with positive incentives to make investments in equipment that would increase efficiency and result in reduced costs, especially where follow-on contracts are involved. Under the current system of negotiating contract prices such investments tend to lower, rather than increase, profits in the long run [40:2].

Soon after the GAO report was published, Lowell H. Goodhue, a senior fellow at LMI stated a similar view.

The familiar competitive market incentive for cost reductions is a combination of profit on new capital invested, improved profit margins, and the expectation of increased sales from reduced selling prices. But on negotiated defense contracts, profit dollars tend to go down in proportion to cost reductions--lower costs do not generally result in proportionate increases in DOD's orders for an item. Under these conditions, there is obvious pressure for a contractor to avoid reducing expected costs [18:98].

In his doctoral dissertation, J. E. Kasputys reviewed the influence of DOD's profit policies on contractor management. He conducted an in depth on-site review of two major

contractors and circulated additional questionnaires to other contractors and procurement agencies in the DOD. One of the hypotheses he tested was:

DOD Profit Policies provide an incentive to contractors to make fewer cost reduction investments in defense work than in comparable commercial work [21:34].

He found considerable support for this hypothesis. Of the two companies he examined, one of them incorporated the profit policy's disincentive for investment into their capital budgeting decisions for cost reducing improvements. Additionally he found that commercial organizational entities invested 40% more for cost reduction than comparable defense entities and that as the percentage of negotiated contract work increased a defense contractor tended to invest even less for cost reduction purposes [21:32].

In response to all the criticism of the WGL, DOD by early 1972 had developed a Profit on Capital Policy. The effort that led to the formulation of this policy was fathered by the 1967 LMI study on needed changes to the WGL. Soon after the LMI study an ASPR subcommittee was established to develop WGL procedures for considering the capital utilized by a defense contractor in determining profit objectives. In 1970 the subcommittee procedures were successfully tested on a sample of 175 contracts. The procedures directed that negotiated profit objectives be based 50% on cost and 50% on capital allocated to the

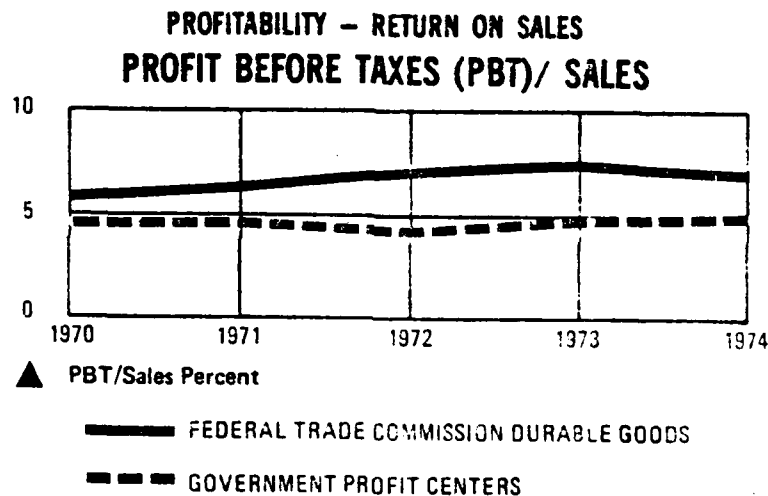
contract [31:110]. Although the Profit on Capital Policy was generally supported by Government and industry in the early stages of development, when it appeared in the ASPR, it received very little use. It was later determined that the policy failed because its use had been made optional and that it was too complex [3:45]. Even though this policy did not see fruition, it was a step in the right direction.

B. CURRENT POLICY

Even though DOD's Profit on Capital Policy failed, there was still concern over the disincentives in DOD's Profit Policy. Additionally by the mid 1970's there was some concern in DOD over the softness of the defense industrial base, its apparent low level of investment and low profitability [37:7]. In May 1975, then Deputy Secretary of Defense William P. Clements chartered a study to review in detail these characteristics. The goal of the study, Profit 76, was to "develop any policy revisions considered necessary to encourage private investment in equipment and the associated reductions in costs [37:8]. In order to fully understand the problem area, the study group looked at the earnings and investments of comparable defense and commercial industries. At the same time opinions on profit issues were garnered from Government and industry. Organizations such as the General Accounting Office, the Cost Accounting Standards Board, and the Office of Federal Procurement

Policy were extensively consulted. Additionally 133 defense contractors provided their thoughts, as well as financial data [37:8].

The first step taken by the study group was a review of investment and earnings of comparable defense and commercial business. The results were divided into two areas. First it was found that when profitability was based on sales, the average for FTC durable goods producers was 6.7% while defense businesses experienced a rate of 4.7% (see Figure 5). [3:43].



SOURCES: Federal Trade Commission
Coopers & Lybrand

Figure 5.

This finding has appeared in other studies but there is less than universal agreement on its significance. Others such as Bohi, and Bicksler and Hess have found that defense business is just as profitable as commercial business but

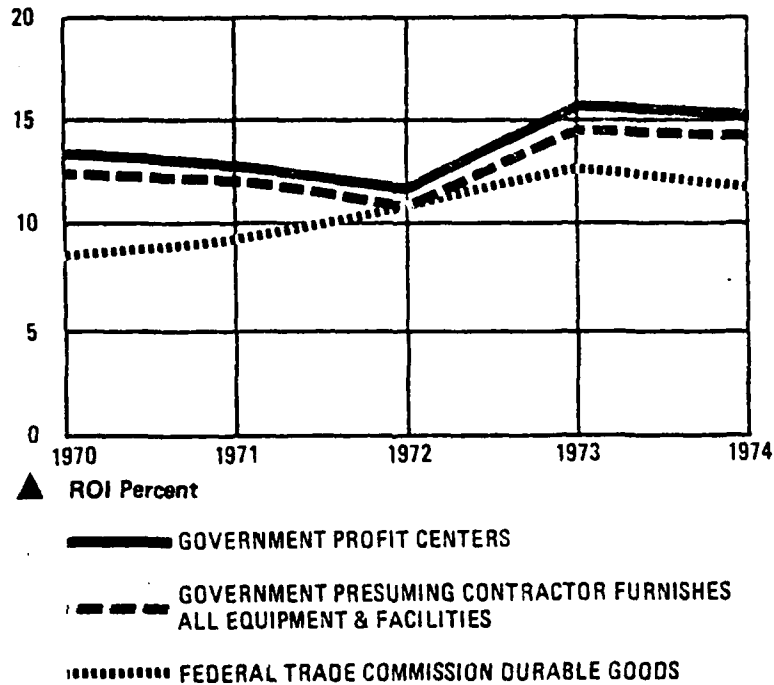
that risk, efficiency and market stability are key factors in determining profitability [6,5].

Second the study group determined that when profitability was based on total assets of an entity that defense business experienced a 13.5% return while commercial business had only a 10.7% return. The effect of government owned equipment was found to be minimal [37:8-10]. In developing a comprehensive understanding of the profitability difference when based on total assets, a comparison was made of investment levels between defense and commercial businesses. Defense businesses were found to invest 35 cents for every dollar of sales while commercial organizations invested 63 cents per dollar of sales. Thirteen cents of the difference was due to the Governments methods of financing contracts-progress and advance payments. The remaining 15 cents was directly related to a lower level of facilities investment by defense contractors [37:11].

The analysis of the data produced a productivity corollary related to investment. Deputy Secretary of Defense William Clements stated in his testimony before the Joint Committee on Defense Production that

...if it is efficient in the commercial marketplace for the FTC durable good producers to employ about 2-1/2 times the amount of facilities per dollar of sales, compared to the defense producer then there are probably productivity gains that could be made if defense contractors increased their investment [37:12].

**PROFITABILITY — RETURN ON INVESTMENT (ROI)
PROFIT BEFORE TAXES/TOTAL ASSETS
(Less Progress and Advance Payments)**



SOURCES: Federal Trade Commission
Coopers & Lybrand [3;43]

Figure 6.

Not only was a detailed analysis of financial data undertaken but 300 contracting officers and 200 companies were surveyed as to their opinions on profit policy. These groups were found to have a modicum of support for basing part of profit on investment and to have a concern that the cost of capital should be more recognized as a portion of product price [37:13].

The major product of Profit 76 was Defense Procurement Circular 76-3 [38]. This circular promulgated two major changes to the DOD Profit Policy in hopes of raising the level of contractor facility investments in defense business. The first change made the imputed cost of capital for facility investment as outlined in Cost Accounting Standard 414 an allowable cost on most negotiated contracts. Second DPC 76-3 made the level of facility investment an important factor in reaching a pre-negotiation objective. The details of the changes are outlined in Figure 7. [37:14]

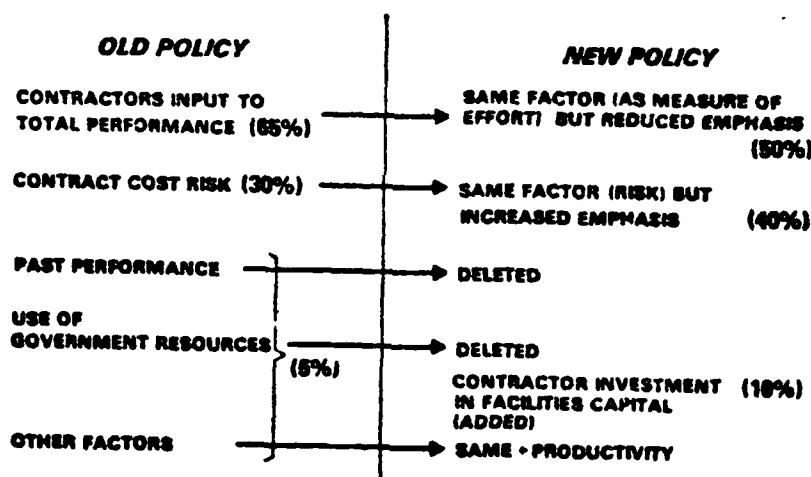


Figure 7. "Profit 76" Changes

Among the minor changes directed by DPC 76-3 was a productivity reward. This tool was located under special factors and was intended to motivate contractors to increase productivity. Contractors were to receive a share of the cost savings that resulted from the productivity improvements.

This approach was theoretically sound but practically fraught with pit falls. The decision to implement the productivity reward in spite of the obvious weaknesses was best characterized by Brigadier General James W. Stansberry. He stated:

...everybody was unanimous in their view that it made sense to try to do it, even though we had not solved all those problems yet...The advice from our contracting officers and industry was give us an open door to try it for a few years to see if we can work out methods...[37:34].

DPC 76-3 was published on 1 September 1976 and became effective 1 October 1976. As foretold by the executive summary to DPC 76-3, weaknesses in the new policy surfaced [38:i]. Grady Jacobs, Chairman of the Defense Department Contract Finance Committee outlined the four major weaknesses of DPC 76-3 in an article in the January 1980 issue of "Contract Management" [20:11].

1. The return on facilities investment is not adequate to be a positive motivation for contractors to increase their facilities investment.
2. Policy guidance for assigning weight to the contract cost risk factor is not sufficient.
3. There are too many exceptions to a manufacturing oriented profit policy.
4. The relationship between R&D and service contract profit levels is not desirable.

In an attempt to overcome these weaknesses, DOD issued DPC 76-23 in February 1980. The weight given to the facilities capital factor was increased to 16-20%, definitive guidance was provided on the cost risk factor, and a separate profit policy was set for research and development and service

contracts. This separate direction was dictated by the large volume of contracts (27% of FY78) that fell under the exemption from complying with WGL [39:2] . Present DOD Profit Policy is attached as Appendix A.

C. CONTINUING PROBLEMS

DOD has been studying, reviewing and implementing ways to reduce the disincentives for investment and cost reduction in its profit policy in hopes of encouraging private investment in productive plant and equipment. Unfortunately even in light of the recent revision to DOD's Profit Policy (DPC 76-23), many of the original problems still exist.

One of the earliest problems, the disincentive to reduce cost is still evident. After reviewing the present policy, G. R. Simonson found that:

The nature of behavior which results in any kind of situation depends significantly upon the system of rewards being offered. In this sense defense profit policy is economically inconsistent with the goals being sought of increased private capital use and lower production costs...profits are maximized by adopting low-capital use, high-cost production methods to increase profits which are a function of costs, and by increasing capital use in non-defense production [36:63].

The converse relationship was confirmed by a study group at the National Defense University. To date there is no conclusive evidence that DOD's Profit Policy has caused any contractor to make any substantial additional investments [12:45]. This is supported by a GAO report that showed that

the facilities capital factor in today's profit policy is too small to be effective [41].

As recognized by Frank A. Shrontz, Assistant Secretary of Defense, in his cover letter to DPC76-3, the causes for "contractor reluctance to invest in modern machinery and equipment for use on DOD contracts are many and varied [38:i]. Many defense contractors seem to see more chances for higher investments coming from these other sources. There appears to be a sense among contractors that an unwritten or unspoken limit to profits has been reached or will soon be. This unenunciated limit comes from public opinion, Congressional oversight, the press, etc. Such a feeling among defense contractors may be a good indicator that factors outside present profit policy may effect investment more. Factors like business stability, more liberal depreciation policies, increased quantities may have more potential for encouraging investment [12:45].

Another problem with today's profit policy is the mechanism for sharing in saving from productivity enhancing investments or decisions. The productivity reward under special factors was designed with the intent of providing a reward to contractors. The idea of reducing costs by increasing productivity and thereby increasing profits is one that is used by business quite often. Kaputys in reviewing two major projects of a defense contractor, one commercial and one military, found that there was much more awareness

of a need to increase productivity and reduce cost in the commercial project. He attributed this awareness to the company's realization that any savings made would be returned to the company as profits. This feeling was not so evident in the defense project [21]. As the productivity reward returns only a small percentage of the savings to the contractor, its effectiveness is somewhat suspect.

These problems are not the only concerns with profit policy but they are the most salient. They have been around the longest and appear to push the policy in unintended directions. Solutions to these problems will help bring profit policy closer to realizing its goals and objectives.

D. SUMMARY

Before addressing Profit Policy's effectiveness, it is important to understand the policy, its development, and current position and problems of implementation. This understanding provides the basis from which to analyze how PCO's feel about the policy and its effectiveness. The analysis of the PCO's feeling about profit policy will be accomplished in Chapter IV.

IV. PRESENTATION OF THE SURVEY DATA

A. INTRODUCTION

As a result of changes in the complexity of weapons systems and materials bought by DOD, the way in which it acquires these items is very different than at the beginning of World War II. No longer is price competition the prime vehicle for buying weapons systems; the purchase of most major systems is a negotiated process. DOD's Profit Policy is one of the many policies, rules, regulations and statutes created to ensure that the Government's best interests are not trampled by contractors. In fulfilling this goal profit policy has been subjected to constant study and review. At each of the major changes in 1963 and 1976 studies have been conducted that review the various aspects of the policy-theory, contractors view, and Government Contracting personnel's perspective. A review of the literature shows that outside of the major studies done at times of change very little research on Government contracting personnel feelings about DOD's Profit Policy has been undertaken. In an attempt to fill a part of this void, this survey of Government Procurement Contracting Officers was undertaken.

B. SURVEY BACKGROUND

Before developing a survey it was necessary to determine what was going to be measured. The current DOD Profit

Policy puts emphasis on

...effective contract performance by which overall costs are economically controlled...(motivating) contractors to provide their own facilities and financing and to establish their competence through development work undertaken at their own risk and reward those who do so; and reward contractors for productivity increases [13:3-808,1b].

Since an in depth study of possible problem areas in implementing Profit Policy was done in conjunction with "Profit 76" [7] it was decided to find out whether or not PCO's felt the policy was meeting its goals. To accomplish this the survey was structured around four areas that effect the policy's effectiveness. These four areas were

1. Policy guidance
2. Organizational emphasis of the policy
3. Policy mechanics
4. Profit Policy's interaction with other policies

A copy of the survey is contained in Appendix B. The questionnaires were sent to 25 major buying commands within DOD. The names of the recipient commands are listed in Appendix C.

As the profit policy is applicable to any type of negotiated contract, no category of buying command was intentionally excluded. This was done to get as complete a picture of the PCO's views on the policy as possible. However, there was one limitation. In order to elicit the respondent's honest and candid responses no means of determining the respondent's command was included in the

questionnaire. It was felt that the information to be gained by recognizing the responding command was overshadowed by the need for truthful and complete answers.

Three steps were used to analyze the surveys. First, they were all separated according to average dollar amounts of contracts handled (contract value groups). This was done in order to determine if the PCO's opinions changed as a function of the contract value group. Second the questions with definite quantifiable responses were analyzed by using a frequency distribution or an arithmetic average of the responses. Third the indefinite responses and comments were reviewed for content. These three methods were used to develop the results outlined in the next section.

C. SURVEY RESPONSES

Of the 370 surveys sent to the 25 major DOD buying activities, 125 were returned (a return rate of 33.8%). Due to the indefinite nature of many of the questions on the survey, many respondents chose not to answer all the questions. As a result, not all the totals and frequencies in the data presentations will add up to 125.

1. Demographic Data

The first group of questions was developed to find out background data on the respondents.

Question 1. How many years experience do you have in your present position?

The experience of the respondents ranged from one month to 30 years with the average being approximately nine years.

To provide a base from which to determine if educational level had a bearing on the respondents opinion of the policy's effectiveness, each respondent was asked to indicate his level of educational achievement.

Question 3. What is the highest educational level you have achieved?

Those who had a bachelors degree or better constituted 77.6% of the respondents while 38.4% had a masters degree or better. The results are shown in Table I.

TABLE I
EDUCATIONAL ACHIEVEMENT LEVEL

Response	Absolute Frequency	Relative Frequency (%)	Cumulative Frequency (%)
High School or less	8	6.4	6.4
Some Bachelors work	20	16	22.4
Bachelors Degree	27	21.6	44
Some Masters work	22	17.6	61.6
Masters Degree	39	31.2	92.8
More Than a Masters	9	7.2	100.0

Total	125	100.0	100.0

Question 4. What is the average dollar value of the contracts you presently work with?

This question was used to provide a basis from which to see if the perception of Profit Policy's effectiveness changed in relationship to the contract value groups. The results were broken down into five groups instead of the six indicated in the survey. Only four respondents indicated handling \$50-100 million contracts. As this number was insignificant, these responses were incorporated with the \$25-50 million group, thus creating a \$25-100 million group.

The responses were fairly evenly distributed among the five groupings with the exception of the \$1-25 million group. It had almost twice as many responses as the other four. Table II summarizes the data.

TABLE II
DISTRIBUTION AMONG CONTRACT VALUE GROUPS

Responses (M=\$Million)	Absolute Frequency	Relative Frequency (%)	Cumulative Frequency (%)
0-.5M	20	16	16.0
.5-1M	21	16.8	32.8
1-25M	40	32	64.8
25-100M	19	15.2	80.0
Over 100M	25	20	100.0

Total	125	100.0	100.0

By combining all the demographic data into one table (Table III) and segregating the data by contract value, several general characteristics becomes evident. First, as might be expected, the PCO's handling the larger dollar value contracts have a higher educational level than those working with smaller dollar values. Second those who work with contracts valued at \$0-500K have been in their present jobs longer than any other group.

TABLE III
COMBINED DEMOGRAPHIC DATA

Contract Value Group (\$; M=Million)	Number of Responses	Average Years Experience	Average Education*
0-.5M	20	11.83	3.55
.5-1M	21	7.5	2.90
1-25M	40	6.07	4.02
25-100M	19	8.58	3.68
Over 100M	25	8.9	4.36

Total	125	8.98	3.73

* 1=High School or less; 2=some bachelors work
3=Bachelors degree; 4=some masters work;
5=Masters degree; 6=more than masters

2. Guidance

For any policy to be effective in accomplishing its goals it must be accurately and completely transmitted to those who implement the policy. Questions six and seven on the survey were developed in order to determine what PCO's felt about the guidance they had received on Profit Policy.

Question 6. How would you classify the guidance you have received on the use and implementation of profit policy as it relates to your every day interaction with the policy?

The respondents to this question seem to have a fairly middle of the road opinion on the guidance for profit policy. Their responses were normally distributed around "Helpful" (Table IV).

TABLE IV
USEFULNESS OF DOD PROFIT POLICY GUIDANCE

Responses	Absolute Frequency	Relative Frequency (%)	Adjusted Frequency (%)
Excellent	9	7.2	7.4
Very Helpful	26	20.8	21.5
Helpful	46	36.8	38.0
Weak	35	28.0	28.9
Useless	5	4.0	4.1
No Response	4	3.2	Missing

Total	125	100.0	99.9

When the responses were broken down by contract value groups, the same distribution held true. Thus it would appear that the guidance received by the PCO's is fairly acceptable to them. The results are summarized in Table V.

TABLE V

USEFULNESS OF PROFIT POLICY GUIDANCE BY CONTRACT VALUE GROUP

Responses	\$0-.5M (%)	.5-1M (%)	1-25M (%)	25-100M (%)	Over 100M (%)
Excellent	0	6	3	16	16
Very Helpful	25	33	15	16	24
Helpful	35	44	36	26	48
Weak	40	11	41	37	8
Useless	0	6	5	5	4

Total	100	100	100	100	100

Question 7. Through what medium have you received most of your guidance on implementing profit policy?

The six sources of guidance were chosen to be representative of the level of management usually associated with that source. DAR is associated with DOD on a broad comprehensive policy and implementation basis. While one step down, policy letters and directives are normally linked with the Office of Federal Procurement Policy, large claimants, or DOD on a less broad basis. DOD Directive 5000.1 on

major system acquisition is a good example. Instructions and memoranda are normally issued by the buying commands themselves and are concerned with the details of how to accomplish particular actions. Finally direct supervisors were included, based on the assumption that a PCO's immediate and direct supervisor would have a major influence on the PCO's actions.

As would be expected, the Defense Acquisition Regulations were the number one source of guidance on profit policy. The second and third sources were policy letters and directives. Fourth, fifth and sixth went respectively to instructions, memos, and direct supervisors. (See Table VI)

Of the nine who thought that the profit policy guidance was excellent, four had been to a training session, workshop, or seminar. Though these numbers are not large, they do indicate a possible medium through which to inform PCO's about profit policy. It may be possible to improve their opinions of the guidance and therefore the policy by holding some type of training sessions. Whether such an approach would be effective is beyond the scope of this research.

3. Organizational emphasis

As was seen in Chapter Three, Government contracting officers' perceptions of management's support for a policy can have a big impact on its effectiveness. DOD's Profit on Capital Policy failed for many reasons but one of the important

TABLE VI
SOURCES OF GUIDANCE
(e.g., of those who indicated a #1 source 47.9% chose DAR)

Responses	Direc- tives (%)	Instruc- tion (%)	Memo (%)	Policy Letter (%)	DAR (%)	Direct Supervisor (%)	Other (%)	Total (%)
1	13.2	9.1	1.7	18.2	47.9	2.5	7.4	100.0
2	23.8	9.9	4.0	23.8	25.7	9.9	3.0	100.0
3	25.6	11.6	10.5	27.9	12.8	7.0	4.7	100.1
4	15.9	29.3	15.9	13.4	6.1	14.6	4.9	100.1
5	8.8	25.0	35.3	7.4	10.3	13.2	---	100.0
6	3.3	16.4	19.7	9.8	4.9	44.3	1.6	100.0

ones was its apparent lack of support among high level Government management [3:45]. In order to detect what emphasis each PCO felt his organization placed on profit policy, Question five was developed.

Question 5. Please list the following policies as to their priority within your organization.

The results indicated that profit policy was not one of the pre-eminent policies in the DOD acquisition process. Of the five policy choices in the question, Competition by a wide margin had top priority, followed by the policy on Small and Disadvantaged Businesses (SDB). These two policies were the only ones with a clear cut ranking. The other three almost seemed to make up a secondary tier of policies. Among profit, standardization, and breakout, there does not appear to be any one that dominates the others as competition and SDB does these three. Such a secondary position in the priorities of an organization may be a contributor to a policy's ineffectiveness. If the investment of private capital by defense contractors is vital to the nation's security then it needs to have more management emphasis and therefore attention from contracting officers. The impact of such management attention is evident in the second place ranking of SDB. Table VII summarizes the responses to Question five.

TABLE VII

ORGANIZATIONAL POLICY PRIORITY

(e.g., of those who indicated an opinion on competition, 72.5% gave it a number priority.)

Priority	Competition (%)	SDB (%)	Profit (%)	Stand. (%)	Breakout (%)
1	72.5	16.5	10.7	5.4	4.5
2	12.5	42.6	19.6	13.4	16.4
3	8.3	20.9	28.6	14.3	25.5
4	3.3	13.0	19.6	35.7	24.5
5	3.3	7.0	21.4	31.3	29.1
<hr/>					
Total	99.9	100.0	99.9	100.1	100.0

4. Policy Mechanics and Operations

To determine if the present Profit policy in DAR was meeting its objectives and goals, the following question was asked:

Question 8. Do you feel that the present DOD Profit Policy as stated in DAR paragraphs 3-808.1, .7, and .8 is capable of motivating defense contractors to invest in new and more productive plant and equipment?

As shown in Table VIII, 71% of those responding felt that profit policy was not capable of motivating contractors to invest in plant and equipment. This is in line with the current thinking of the General Accounting Office and the defense industries.

TABLE VIII

IS PROFIT POLICY CAPABLE OF MOTIVATING
CONTRACTOR INVESTMENT IN PLANT AND EQUIPMENT?

Response	Absolute Frequency	Relative Frequency (%)	Adjusted Frequency (%)
Yes	33	26.4	29.2
No	80	64.0	70.8
No Response	12	9.6	missing
Total	125	100.0	100.0

When the results shown in Table VIII are broken down by contract value groups, each group follows the trend of the whole sample with the exception of the \$0-.5 million group. The PCO's in this category overwhelmingly felt that the present policy was capable of motivating contractors to invest. The tabulated results are shown in Table IX.

TABLE IX

TABLE VIII RESPONSES BY CONTRACT VALUE GROUP

Response	Contract Value Groups (M=\$Million)				
	0-.5M (%)	.5-1M (%)	1-25M (%)	25-100M (%)	Over 100M (%)
Yes	65	30	26	24	13
No	35	70	74	76	87
Total	100	100	100	100	100

In view of the controversy surrounding the profit policy's ability to achieve its goal, the following question was asked to determine whether profit was the appropriate tool to increase investments by defense contractors.

Question 9. Do you feel that profit policy is the proper tool for incentivizing contractors to increase their investments in plant and equipment?

The PCO's opinions on this question were not overwhelmingly different. Profit policy was supported as the proper tool to incentivize contractor investment by 43% of the PCO's while 57% did not.

TABLE X
IS PROFIT POLICY THE PROPER TOOL
TO ENCOURAGE CONTRACTOR INVESTMENT?

Response	Absolute Frequency	Relative Frequency (%)	Adjusted Frequency (%)
Yes	50	40.0	43.1
No	66	52.8	56.9
No Response	9	7.2	missing
Total	125	100.0	100.0

Segregating the above data by contract value groups, as in Table XI, results in showing the PCO's opinion in a different light. Those who handle contracts up to \$25 million have opinions directly opposite those who handle

contracts over \$25 million. 53.3% of the under \$25 million group felt that profit policy was the correct tool while of those handling actions over \$25 million only 24.4% felt that it was.

TABLE XI

IS PROFIT POLICY THE PROPER TOOL
TO ENCOURAGE CONTRACTOR INVESTMENT?
(By Contract Value Group)

Response	Contract Value Groups	
	Under \$25 Million (%)	Over \$25 million (%)
Yes	53.3	24.4
No	46.7	75.6

Total	100.0	100.0

These questions generated a substantial number of comments. Among those who indicated that profit policy was not a proper tool, their comments fell in the following categories:

- 1) The amount of incentive available was not sufficient.
- 2) DOD programs lack stability
 - a. No guarantee of future business
 - b. Insufficient volume
- 3) Profit policy is only one tool among many.
- 4) The policy is cost based and not theoretically sound.
- 5) Interest rates are so high that they destroy profit margins.

The following opinions were expressed by a small number of respondents from the same group:

- 1) Profit policy is short term, and capital expenditures are long term.
- 2) Due to a winner take all philosophy, government contracts are few and far between.

The PCO's who felt that profit policy was the proper tool made comments that encompassed the following areas:

- 1) Contractors are only interested in profit.
- 2) Profit policy works if properly implemented and monitored.
- 3) Best fits free market.
- 4) There is no alternative.

After determining the PCO's opinion on the overall effectiveness of profit policy, Question 12 was designed to find out if two key elements of the policy, the productivity reward and facilities capital, were effective.

Question 12. In your experience has a contractor changed his capital expenditures because of the productivity reward or the facilities capital sections of the weighted guidelines?

The results shown in Table XII indicate that these two key elements have had little effect on contractors investment. 87.8% of the respondents felt that no contractor investments had been made because of profit policy provisions. The major weakness indicated by the comments was that the rewards offered were too small and at the same time too hard to administer. This feeling was reinforced by one response which told of a PCO being laughed at by a contractor when productivity reward was mentioned. Other weaknesses pointed out by the comments are listed below:

- 1) They are not applicable; competition and production needs dictate investment.
- 2) Lack of program stability, insufficient quantities.
- 3) Government policy changes too often to make an investment decision based on it.
- 4) Government contracting officers do not understand productivity reward and/or are not allowed to use it.
- 5) Since negotiations often end by agreeing on final price, government ends up backing into profit objective and therefore profit policy loses its incentive.

Of the PCO's answering question twelve only 12.2% said that profit policy had caused a change in contractor behavior. The comments made fell into two basic categories.

- 1) The key elements of profit policy help contractors maximize profit.
- 2) They help a contractor quickly recoup costs.

TABLE XII

HAS A CONTRACTOR CHANGED HIS CAPITAL EXPENDITURES
BECAUSE OF PROFIT POLICY PROVISIONS?

Response	Absolute Frequency	Relative Frequency (%)	Adjusted Frequency (%)
Yes	11	8.8	12.2
No	79	63.2	87.8
No Response	35	28.0	missing
Total	125	100.0	100.0

5. Interaction With Other Policies

Question 10. What other Government, departmental, agency, etc., policies do you feel have a positive influence on the effectiveness of the profit policy?

Question 11. What other policies do you feel have a negative influence on the effectiveness of DOD's Profit Policy?

The responses to these questions were many and varied. The number of negative responses far out weighed the positive. The positive responses centered around the following policies:

- 1) Multiyear Contracting
- 2) Need for Competition
- 3) CAS 414
- 4) Increased use of Firm Fixed Price Contracts

Additional comments were made concerning local actions that had had a positive effect on profit policy. The comments pointed to good local implementation and a good management attitude toward profit.

The detrimental impact of the socio-economic goals and plans applied to the contracting process was the major negative response given to question eleven. Many felt that the cost of implementing these socio-economic programs took needed funds away from capital investment. This adds support to the finding that profit is a low priority policy in the PCO's organizations. If PCO's feel that the effectiveness of profit policy is hurt by socio-economic programs and they observe that the policy on Small and Disadvantaged Businesses is given a top priority in their organizations,

it can mean only one thing--the objectives of profit policy are not important enough to warrant their time and effort. Therefore there is little reason to wonder why profit policy's effectiveness is weak--there is not enough organizational support. Based on these findings it would appear that DOD has made the decision that the goals of the SDB policy are presently more important than those of profit policy.

Additional comments centered on the following policies having a negative effect on profit policy:

- 1) Weak Multiyear Contracting Policy
- 2) Tax Policies
- 3) Component Break out
- 4) CAS414--cost or a profit

Beyond the negative impact of stated Government policies, respondents felt that there was an unstated policy among higher levels of Government management that the only good profit is a low one. This assertion was developed from comments by PCO's on inconsistent implementation of profit policy by Government management, arbitrary profit limits set by local contract review boards, and the basing of profit rates on prior contracts. One respondent cited an example where the present profit policy was used to reward and motivate as much as possible. This complete use of the policy resulted in the small business contractor receiving a profit rate of 21% on cost. When the contract review board considered the contract, it was rejected and the PCO

told to reduce the profit to 13%. Other responses also cited arbitrary limitations set by local review boards as problems. Some PCO's felt that compounding the above problems was the winner take all characteristic of the acquisition process.

6. Recommended Improvements

Question 13. Do you have any recommendations for improving the incentives mentioned in the previous question?

The comments by those who gave specific recommendations were small in numbers. Their recommendations were the following:

- 1) Overhaul the weighted guidelines.
- 2) Force contractors to spend CAS 414 money on plant and equipment.
- 3) Improve the productivity reward.

The majority of the PCO's who responded to this question gave general recommendations for improving profit policy. The most popular recommendation was a perceived need to revise tax policies. The most desired revision to tax policy was for faster depreciation of capital assets or a large tax credit for investment. One respondent suggested that any profits reinvested in the company's plant and equipment should be tax free. A somewhat surprising and popular recommendation was the need for additional training of Government and contractor personnel in the use of profit policy. Many PCO's seemed to feel that if the implementers, the negotiators and price analysts, were better trained

and knew how to use the policy's incentives that the policy would be more effective.

Three other recommendations were widely advocated, but not to the extent of the two mentioned above. First, it was recommended that DOD pay profits comparable to those in the private sector. A related proposal urged a more liberal view of what is an acceptable profit by DOD and the elimination of unwritten limits on profit. Second, the wide use of multi-year or long term contracts was recommended. Finally the elimination of unallowable costs was proffered as a way to improve profit policy. The most often mentioned candidate for elimination was the unallowable expense for interest.

The following are pertinent comments that do not fit into any of the above recommendations:

- 1) Use some method not attached to negotiations.
- 2) Use long range dual source planning to establish competition.
- 3) The Government should provide low cost loans for plant and equipment.

D. SUMMARY

The main focus of this chapter has been to reflect the major opinions of PCO's regarding the effectiveness of DOD's Profit Policy. This was accomplished by examining the responses made by PCO's to a questionnaire prepared by the author. The questionnaire sought to express PCO opinion on various aspects of the policy and its effectiveness. The

responses to each of the survey questions, where applicable,
were summarized in tables or narrative form.

V. PRINCIPAL FINDINGS, CONCLUSIONS, RECOMMENDATIONS

A. FINDINGS AND CONCLUSIONS

The objective of this study was to contribute accurate data reflecting DOD PCO's opinions on the effectiveness of the Department of Defense's present profit policy. The principal findings and conclusions were derived from the questionnaire response data discussed in the previous chapter:

1. DOD PCO's generally found profit policy ineffective in motivating contractors to invest in more productive plant and equipment. The present policy was not capable of motivating defense contractors according to 71% of the responding PCO's. Additionally the specific incentives of facilities capital and the productivity reward are having little or no effect on contractor investment. The survey results showed that 87.2% of the PCO's felt that the contractors they had worked with had not changed their capital expenditure plans because of provisions of the profit policy.

2. In a related finding, the correctness of using profit policy to motivate contractors to invest was supported by 53.3% of the PCO's handling contracts valued under \$25 million and was soundly rejected (only 24.4% supported profit policy as the correct tool) by those who worked with contracts over \$25 million.

3. Major contributing factors to the policy's ineffectiveness were the impact of socio-economic programs implemented through the contracting process and program instability. Many responses cited the impression that the cost to business of implementing these programs took needed capital away from investment opportunities. The problems of insufficient volume and uncertainty over future business were major concerns expressed by the PCO's in the area of program stability.

4. DOD Profit Policy is not a high priority policy within DOD procuring activities. Only 30% of the PCO's indicated that profit was a high priority policy in their organizations while 85% and 59% respectively indicated that competition and Small and Disadvantage Business policy were top priorities in their organizations. The PCO's perception of profit policy's low priority and the SDB policy's much higher priority, in conjunction with the perceived detrimental impact of socio-economic programs on profit policy's effectiveness would seem to indicate that DOD has decided that the SDB policy is more important than profit policy. This conclusion leads to the assumption that present Government management's emphasis is on the SDB policy and not profit. This lack of emphasis on profit policy may be considered one of the contributing factors to its ineffectiveness.

5. There is an unstated policy among upper level management in the DOD acquisition process that the only good profit is a low one. PCO's mentioned contract review boards as one source of such an unstated policy.

6. PCO's felt that changes in the tax laws and a training program on profit policy would improve the policy's effectiveness. The recommended changes in the tax laws centered around the need for faster depreciation and/or a tax credit for investment in plant and equipment. The need for a training program was based on the PCO's perception that many contracting personnel including upper level management, did not understand profit policy and therefore could not effectively use it.

B. RECOMMENDATIONS

1. DOD should review the goals and objectives of profit policy and determine what priority they should have in relation to other DOD policies. If its priority is found lacking a profit policy training program should be initiated by the Office of the Secretary of Defense (OSD). The participation of OSD is critical because the apparent interest by DOD leadership makes the importance of such a policy very evident to other layers of management. This interest should not be short lived but continue throughout the training program. This program should impart to attendees not only the mechanics of the policy and the theory and philosophy behind it but also its goals and objectives.

2. DOD should lend its support to legislation increasing the rates of depreciation for plant and equipment. From the responses given by the PCO's, it would appear that the passage of such legislation would substantially increase contractor investment, one of profit policy's goals.

3. It is recommended that further research be conducted in regards to whether profit policy is the proper tool for motivating defense contractors to invest in plant and equipment. The apparent difference in opinion among PCO's outlined in finding two indicates that there must be different circumstances operating above and below the \$25 million dividing point. It is envisioned that further research would provide a clear picture of the differences and therefore make it possible to improve profit policy's application in these two areas.

APPENDIX A

3-808 Profit, Including Fees Under Cost-Reimbursement-Type Contracts.

3-808.1 Policy.

(a) *General.* It is the policy of the Department of Defense to utilize profit to stimulate efficient contract performance. Profit generally is the basic motive of business enterprise. The Government and defense contractors should be concerned with harnessing this motive to work for more effective and economical contract performance. Negotiation of very low profits, the use of historical averages, or the automatic application of a predetermined percentage to the total estimated cost of a product, does not provide the motivation to accomplish such performance. Furthermore, low average profit rates on defense contracts overall are detrimental to the public interest. Effective national defense in a free enterprise economy requires that the best industrial capabilities be attracted to defense contracts. These capabilities will be driven away from the defense market if defense contracts are characterized by low profit opportunities. Consequently, negotiations aimed merely at reducing prices by reducing profits, with no realization of the function of profit, cannot be condoned. For each contract in which profit is negotiated as a separate element of the contract price, the aim of negotiation should be to employ the profit motive so as to impel

3-808 1

effective contract performance by which overall costs are economically controlled. To this end, the profit objective must be fitted to the circumstances of the particular acquisition, giving due weight to each of the effort, risk, facilities investment, and special factors set forth in this 3-808. This will result in a wider range of profits which, in many cases, will be significantly higher than previous norms.

(b) *Contracts Priced on the Basis of Cost Analysis.* When cost analysis is performed pursuant to 3-807.2, profit consideration shall be in accordance with the objectives set forth below. The Government should establish a profit objective for contract negotiations, which will—

- (i) motivate contractors to undertake more difficult work requiring higher skills and reward those who do so;
- (ii) allow the contractors an opportunity to earn profits commensurate with the extent of the cost risk they are willing to assume;
- (iii) motivate contractors to provide their own facilities and financing and to establish their competence through development work undertaken at their own risk and reward those who do so; and
- (iv) reward contractors for productivity increases.

The weighted guidelines method set forth in 3-808.2 for establishing profit objectives is designed to provide reasonably precise guidance in applying these principles. This method, properly applied, will tailor profits to the circumstances of each contract in such a way that long-range cost-reduction objectives will be fostered, and a spread of profits will be achieved that is commensurate with varying circumstances.

(c) *Contracts Priced Without Cost Analysis.* On many contracts and subcontracts, good pricing does not require an examination into costs and profits. Where adequate price competition exists, and in other situations where cost analysis is not required (see 3-807), fixed-price-type contracts should be awarded to the lowest responsible offerors without regard to the amount of their profits. Under these circumstances, the profit that is anticipated or, in fact, earned should not be of concern to the Government. In such cases, if a low offeror earns a large profit, it should be considered the normal reward of efficiency in a competitive system and efforts shall not be made to reduce such profits.

3-808.2 Weighted Guidelines Method.

(a) General.

(1) The weighted guidelines method provides contracting officers with (i) a technique that will insure consideration of the relative value of the appropriate profit factors described in 3-808.4 in the establishment of a profit objective and the conduct of negotiations; and (ii) a basis for documentation of this objective, including an explanation of any significant departure from it in reaching a final agreement. The contracting officer's analysis of these profit factors is based on information available prior to negotiations. Such information is furnished in proposals, audit data, performance reports, preaward surveys and the like. Except as set forth in (b) below, the weighted guidelines method shall be used in the negotiation of all contracts where cost analysis is performed for:

3-808.2

- (i) the manufacturing of supplies and equipment;
- (ii) research and development as described in 4-101(a)(1) through (5), encompassing research, exploratory development, advanced development, engineering development, and operational systems development;
- (iii) services as described in 4-101(a)(6) and 22-101.

a. The profit objective for manufacturing contracts shall be computed, except as indicated in e. below, using the manufacturing weighted guidelines method, which provides profit opportunity based on facilities capital investment.

b. The profit objective for research and development contracts shall be computed using the research and development weighted guidelines method unless, in the judgement of the contracting officer, a significant amount of facilities is required for efficient contract performance, in which case the manufacturing weighted guidelines shall be used.

c. The profit objective for service contracts shall be computed using the service contract weighted guidelines method unless, in the judgement of the contracting officer, a significant amount of facilities is required for efficient contract performance, in which case the manufacturing weighted guidelines shall be used.

d. In determining whether a particular contract shall be classified as manufacturing, research and development, or services, primary reliance shall be placed on the nature of the work to be performed, as indicated by the coding for item 10A of the DD Form 350 (see DOD 4105.61-M, Department of Defense Procurement Coding Manual, Volume 1), notwithstanding the appropriation or negotiation authority used. The following guidelines shall apply:

- (i) *Manufacturing Weighted Guidelines.* Contracts coded under Section I, Part C, Supplies and Equipment.
- (ii) *Research and Development Weighted Guidelines.* Contracts coded under Section I, Part A, Research, Development, Test and Evaluation, except for contracts coded as AD2-, Defense Services, and A- -6, Management and Support.
- (iii) *Services Weighted Guidelines.* Contracts coded under Section I, Part B, Other Services and Construction; and under Section I, Part A, as AD2- and as A- -. Note, however, that there are blanket exceptions for certain services in 3-808.2(b).

e. The categories listed above are intended to be used as a point of departure in determining which weighted guidelines method applies. Many contracts for research and development and for services will require a significant amount of facilities for efficient contract performance. When this is the case, the manufacturing weighted guidelines method shall be used. Similarly, certain contracts for the manufacture of small quantities of high technology supplies and equipment may not require a significant amount of facilities. In such cases, the research and development weighted guidelines method shall be used. Contracting officers shall apply sound judgement in determining which weighted guidelines method is most appropriate for a particular contracting situation. The difference in profit objectives that would result from the applica-

tion of alternative weighted guidelines methods shall not be a consideration in making this determination.

f. In determining whether a significant amount of facilities is required for efficient contract performance, the contracting officer should assess the facilities needed, including contractor owned and leased and Government owned. When there is a relatively small amount of facilities capital cost of money allocated to the contract because some facilities are provided through operating leases and by the Government, this does not necessarily mean that an insignificant amount of facilities is required for efficient contract performance.

g. When a method other than the manufacturing weighted guidelines method is used to establish the prenegotiation profit objective, the profit objective shall be reduced by the amount of facilities capital cost of money allowed in accordance with 15-205.50. If the contractor does not propose this cost, a provision shall be inserted in the contract that facilities capital cost of money is not an allowable cost (see 3-501, Part I, Section H(iv)). On cost-plus-award-fee contracts, the base fee shall be reduced by the amount of facilities capital cost of money or the contract shall contain a provision to disallow the cost.

(2) The contractor's proposal should include cost information for evaluation and a total profit figure. Contractors shall not be required to submit the details of their profit objectives but they shall not be prohibited from doing so if they desire. Elaborate and voluminous presentations are neither required nor desired and may indicate a low index of cost effectiveness, which fact itself shall be taken into consideration by the contracting officer.

(3) The negotiation process does not contemplate or require agreement on either estimated cost elements or profit elements, although the details of analysis and evaluation may be discussed in the fact-finding phase of the negotiation. If the difference between the contractor's profit objective and the contracting officer's profit objective is relatively small, no discussion of individual factors may be necessary. If the negotiating parties' objectives are relatively far apart, a disclosure of weightings and rationale by both parties may be made concerning the total assigned to contractor effort, contractor risk, facilities investment, and special factors. By thus developing a mutual understanding of the logic of the respective positions, an orderly progression to final agreement should result. Simultaneous, not sequential, agreement will be reached on cost, any incentive profit-sharing formulas or limitation on profits, and price. The profit objective is a part of an overall negotiation objective which, as a going-in objective, bears a distinct relationship to the target cost objective and any proposed sharing arrangement. Since the profit is merely one of several interrelated variables, the Government negotiator shall not complete the profit negotiation without simultaneously agreeing on the other variables. Specific agreement on the exact weights or values of the individual factors is not required and shall not be attempted.

(b) Exceptions.

(1) Under the following listed circumstances, other methods for establishing profit objectives may be used.

- (i) Architect-engineering contracts;
- (ii) Management contracts for operation and/or maintenance of Government facilities;
- (iii) Construction contracts;
- (iv) Contracts primarily requiring delivery of material supplied by subcontractors;
- (v) Termination settlements;
- (vi) Cost-plus-award-fee contracts;
- (vii) Contracts not expected to exceed \$100,000; and
- (viii) Unusual pricing situations where the weighted guidelines method has been determined to be unsuitable. Such exceptions shall be justified in writing and shall be authorized by the head of the contracting activity.

(2) If the contracting officer makes a written determination that the pricing situation meets any of the circumstances set forth above and that application of the manufacturing weighted guidelines will result in an inequitable profit objective, other methods for establishing the profit objective may be used. These methods shall be supported in a manner similar to that used in the weighted guidelines (profit factor breakdown and documentation of profit objectives); however, investment or other factors that would not be applicable to the contract shall be excluded from the profit objective determination. It is intended that the methods will result in profit objectives for noncapital intensive contracts that are below those generally developed for capital intensive contracts.

(c) *Application to Subcontracts.* The prime contractor may use the weighted guidelines or a structured approach that discriminates among different levels of investment if the acquisition would be subject to the weighted guidelines under a prime contract. (For applicability see 3-1300.1(c).) If the acquisition falls into one of the exceptions to the weighted guidelines in 3-808.2(b)(1), the prime contractor may use another method to establish profit objectives. In the absence of a structured approach that discriminates among different levels of investment, similar to the weighted guidelines, the profit objective will be reduced by the amount of facilities capital cost of money allowed in accordance with 15-205.50.

(d) *Limitation.* In the event this or any other method would result in establishing a fee objective in violation of limitations established by statute or this regulation, the maximum fee objective shall be the percentage allowed pursuant to such limitations. (See 3-405.) No local administrative ceilings on profit shall be permitted.

3-808.3 Profit Objective.

(a) A profit objective is that part of the estimated contract price objective or value which, in the judgment of the contracting officer, is appropriate for the acquisition being considered, covering the profit or fee element of the price objective. This objective should realistically reflect the total overall task to be performed and the requirements placed on the contractor. Prior to the negotiation of a contract, change order, or contract modification where cost analysis is undertaken, the negotiator shall develop a profit objective. The weighted

guidelines method, if applicable, shall be used for developing this profit objective. If a change or modification is of a relatively small dollar amount and is basically the same type of work as required in the basic contract, the application of the weighted guidelines method will generally result in a profit objective similar to the profit objective in the basic contract and, therefore, this basic rate may be applied to the contract change or modification. In cases where the change or modification calls for substantially different work, then the basic contract profit and the contractor's effort may be radically changed and a detailed analysis is necessary. Also, if the dollar amount of the change or contract modification is very significant in comparison to the contract dollar amount, a detailed analysis shall be made.

(b) Development of a profit objective should not begin until after a thorough—

- (i) review of proposed contract work;
- (ii) review of all available knowledge regarding the contractor, pursuant to Section I, Part 9, including capability reports, audit data, preaward survey reports and financial statements, as appropriate; and
- (iii) analysis of the contractor's cost estimate and comparison with the Government's estimate or projection of cost.

3-808.4 Profit Factors.

(a) The following factors shall be considered in all cases in which profit is to be specifically negotiated. The weight ranges listed after each factor shall be used in all instances where the weighted guidelines method is used.

	WEIGHT RANGES		
	Manufacturing*	R&D	Services
A. CONTRACTOR EFFORT			
Material Acquisition			
Subcontract Items	1 to 5%	1 to 5%	1 to 5%
Purchased Parts	1 to 4%	1 to 4%	1 to 4%
Other Material	1 to 4%	1 to 4%	1 to 4%
Engineering			
Direct Labor	9 to 15%	9 to 15%	N/A
Manufacturing			
Direct Labor	5 to 9%	5 to 9%	N/A
Services			
Direct Labor	N/A	N/A	5 to 15%
Overhead	N/A	N/A	4 to 8%
Other			
General Management	6 to 8%	6 to 8%	6 to 8%
B. CONTRACTOR RISK	0 to 8%	0 to 7%	0 to 4%
C. FACILITIES INVESTMENT	16 to 20%	N/A	N/A
D. SPECIAL FACTORS			
Productivity	See 3-808.8(a)	N/A	N/A
Independent Development	1 to 4%	1 to 4%	N/A
Other	-5 to +5%	-5 to +5%	-5 to +5%

* An adjustment factor of .7 is applied to the results of the Contractor Effort evaluation to arrive at the dollar profit objective for this factor (see DD Form 1547). Also see 3-1300.5(a)(2).

(b) Under the weighted guidelines method, the contracting officer shall first measure the "Contractor's Effort" by the assignment of a profit percentage, within the designated weight ranges, to each element of contract cost recognized by the contracting officer. Although certain classifications of acceptable cost, including travel, subsistence, facilities, test equipment, special tooling, federal manufacturers' excise taxes, and royalty expenses, may have been historically excluded from the base upon which profit has been computed, they shall not be excluded when using the weighted guidelines method. Not to be included for the computation of profit as part of the cost base is the amount calculated for the cost of money for facilities capital. How this cost is determined and how it will be applied and administered is fully set forth in 3-1300.

(c) The suggested categories under the Contractor's Effort are similar to those on the Contract Pricing Proposal (DD Form 633). Often, individual proposals will be in a different format, but, since these categories are broad and basic, they provide sufficient guidance to evaluate all other items of cost.

(d) After computing a total dollar profit for the Contractor's Effort, the contracting officer then shall add the specific profit dollars assigned for cost risk, facilities investment risk, and special factors. Weighted Guidelines Profit/Fee Objective (DD Form 1547) is to be used, as appropriate, to facilitate the calculation of this profit objective. (See F-200.1547.)

(e) The weighted guidelines method was designed for arriving at profit or fee objectives for other than nonprofit organizations. However, if appropriate adjustments are made to reflect differences between profit and nonprofit

organizations, the weighted guidelines method can be used as a basis for arriving at fee objectives for nonprofit organizations. Therefore, the policy of the Department of Defense is to use the weighted guidelines method, as modified in (2) below, to establish fee objectives that will stimulate efficient contract performance and attract the best capabilities of nonprofit organizations to defense-oriented activities. The modifications shall not be applied as deductions against historical fee levels but to the fee objective for such a contract, as calculated under the weighted guidelines method.

(1) For purposes of this subparagraph, nonprofit organizations are defined as those business entities organized and operated exclusively for charitable, scientific, or educational purposes, of which no part of the net earnings inure to the benefit of any private shareholder or individual, of which no substantial part of the activities is carrying on propaganda or otherwise attempting to influence legislation or participating in any political campaign on behalf of any candidate for public office, and which are exempt from Federal income taxation under Section 501 of the Internal Revenue Code.

(2) For contracts with nonprofit organizations where fees are involved, the following adjustments are required in the weighted guidelines method.

(i) An adjustment of -1 percent of the total effort shall be assigned in all cases where the manufacturing weighted guidelines method is used. An adjustment of -3 percent of the total effort shall be assigned in all cases where the research and development or services weighted guidelines method is used.

(ii) The weight range under "Contractor Cost Risk" shall be -1 percent to 0 percent in lieu of 0 percent to 8 percent for contracts with those nonprofit organizations, or elements thereof, identified by the Secretary of Defense or the Secretary of a Department (or their respective designees) as receiving sustaining support on a cost-plus-a-fixed-fee basis from a particular Department or Agency of the Department of Defense.

(f) In making a judgment of the value of each factor, the contracting officer should be governed by the definition, description, and purpose of the factors, together with considerations for evaluating them as set forth herein.

3-808.5 Contractor Effort.

(a) *General.* This factor is a measure of how much the contractor is expected to contribute to the overall effort necessary to meet the contract performance requirements in an efficient manner. This factor, which is apart from the contractor's responsibility for contract performance, takes into account what resources are necessary and what the contractor must do to accomplish a conversion of ideas and materials into the final product called for in the contract. This is a recognition that, within a given performance output or within a given sales dollar figure, necessary efforts on the part of individual contractors can vary widely in both value and quantity, and that the profit objective should reflect the extent and nature of the contractor's contribution

to total performance. The evaluation of this factor requires an analysis of the cost content of the proposed contract as follows.

(b) *Material Acquisition (Subcontracted Items, Purchased Parts, and Other Material)*. Analysis of these cost items shall include an evaluation of the managerial and technical effort necessary to obtain the required purchased parts, subcontracted items, and other materials, including special tooling. This evaluation shall include consideration of the number of orders and suppliers and whether established sources are available or new sources must be developed. The contracting officer shall also determine whether the contractor will obtain the material and tooling by routine orders from readily available supplies (particularly those of substantial value in relation to the total contract cost) or by detailed subcontracts, for which the prime contractor will be required to develop complex specifications involving creative design or close tolerance manufacturing requirements. Consideration shall be given to the managerial and technical efforts necessary for the prime contractor to administer subcontracts and select subcontractors, including efforts to break out subcontracts from sole sources through the introduction of competition. These determinations shall be made for purchases of raw materials or basic commodities, purchases of processed material, including all types of components of standard or near standard characteristics, and purchases of pieces, assemblies, subassemblies, special tooling, and other products special to the end item. In the application of this criterion, it should be recognized that the contribution of the prime contractor to his purchasing program may be substantial. This may apply in the management of subcontracting programs involving many sources, new complex components and instrumentation, incomplete specifications, and close surveillance by the prime contractor's representative. Recognized costs proposed as direct material costs, like scrap charges, shall be treated as material for profit evaluation. If intracompany transfers are accepted at price, in accordance with 15-205.22(e), they shall be evaluated as material. Other intracompany transfers shall be evaluated by individual components of cost, i.e., material labor, and overhead. Normally, the lowest unadjusted weight for direct material is 2 percent. A weighting of less than 2 percent would be appropriate only in unusual circumstances when there is a minimal contribution by the contractor.

(c) *Conversion (Engineering, Manufacturing, and Service Labor)*. Analysis of the engineering, manufacturing, and service labor items of the cost content of the contract shall include evaluation of the comparative quality and level of the engineering talents, manufacturing and service skills, and experience to be employed. In evaluating engineering labor for the purpose of assigning profit dollars, consideration shall be given to the amount of notable scientific talent or unusual or scarce engineering talent needed in contrast to journeyman engineering effort or supporting personnel. The diversity, or lack thereof, of scientific and engineering specialties required for contract performance and the corresponding need for engineering supervision and coordination shall be evaluated. Similarly, the variety of manufacturing labor skills required and the contractor's manpower resources for meeting these requirements shall be considered. Service contract labor shall be evaluated in a like manner by

assigning higher weights to engineering or professional-type skills and lower weights to semiprofessional or other type skills required for contract performance. A weighting in excess of 10 percent for service contract labor will be justified normally only when the quality, skill, and experience of the service contract labor warrants a corresponding weighting under a research and development contract.

(d) *General Management (Overhead and G&A).*

(1) Analysis of these overhead items of cost includes the evaluation of the makeup of these expenses and how much they contribute to contract performance. This analysis shall include a determination of the amount of labor within these overhead pools and how this labor would be treated if it were considered as direct labor under the contract. The allocable labor elements shall be given the same profit consideration that they would receive if they were treated as direct labor. The other elements of these overhead pools shall be evaluated to determine whether they are routine expenses, like utilities, depreciation, and maintenance, and hence given lesser profit consideration, or whether they are significant contributing elements. The composite of the individual determinations in relation to the elements of the overhead pools will be the profit consideration given the pools as a whole. The procedure for assigning relative values to these overhead expenses differs from the method used in assigning values of the direct labor. The upper and lower limits assignable to the direct labor are absolute. In the case of overhead expenses, individual expenses may be assigned values outside the range as long as the composite ratio is within the range.

(2) It is not necessary that the contractor's accounting system break down the overhead expenses within the classifications of engineering overhead, manufacturing overhead, and general and administrative expenses, unless dictated otherwise by Cost Accounting Standards (CAS). The contractor whose accounting system only reflects one overhead rate on all direct labor need not change the system (if CAS exempt) to correspond with the above classifications. In evaluating such a contractor's overhead rate, the contracting officer can break out the applicable sections of the composite rate which can be classified as engineering overhead, manufacturing overhead, and general and administrative expenses and follow the appropriate evaluation technique.

(3) There is a critical factor to consider in the determination of profit in this area. Management problems surface in various degrees and the management expertise exercised to solve them shall be considered as an element of profit. For example, a new program for an item that is on the cutting edge of the state of the art will cause more problems and require more managerial time and abilities of a higher order than a follow-on contract. If new contracts create more problems and require a higher profit weight, follow-ons shall be adjusted downward as many of the problems shall have been solved. In any event an evaluation shall be made of the underlying managerial effort involved on a case-by-case basis.

(4) It may not be necessary for the contracting officer to make a separate profit evaluation of overhead expenses with each acquisition of substantially the same product with the same contractor. Where an analysis of

the profit weight to be assigned to the overhead pool has been made, the weight assigned may be used for future contracts with the same contractor until there is a change in the cost composition of the overhead pool or the contract circumstances, or until the factors discussed in (3) above are relevant.

3-808.6 Contract Cost Risk.

(a) General.

(1) This factor reflects the policy of the Department of Defense that contractors bear an equitable share of contract cost risk, and to compensate them for the assumption of that risk. A contractor's risk associated with costs to perform under a Government contract is usually minimal under cost-reimbursement-type contracts. However, as acquisitions progress from basic research through follow-on production and supply contracts, the use of increased contractor-risk-assumption-type contracts is appropriate for increasing the contractor's responsibility for performance. The generally accepted progression of the acquisition spectrum ranging from basic research through supply acquisitions and from cost to firm fixed-price contracts, is shown below:

TYPE OF EFFORT	TYPE OF CONTRACT
1. Basic Research	Cost, CPFF
2. Applied Research	Cost, CPFF
3. Exploratory Development	Cost, CPFF
4. Advanced Development	CPFF, CPAF
5. Engineering Development	CPFF, CPAF, CPIF
6. Operational System Development	CPIF, CPAF, FPI
7. First Production	FPI
8. Follow-on Production	FPI, FFP
9. Supply	FFP

Research and the various categories of development are defined in 4-101.

(2) In developing the prenegotiation profit objective, the contracting officer will need to consider strongly the type of contract anticipated to be negotiated and the associated contractor risk when selecting the position in the weight range for profit that is appropriate for the risk to be borne by the contractor. This is one of the most important factors in arriving at prenegotiation profit objectives.

(b) Evaluation of Contractor's Assumption of Contract Cost Risk.

(1) Evaluation of this risk requires a determination of (i) the degree of cost responsibility the contractor assumes, (ii) the reliability of the cost estimates in relation to the task assumed, and (iii) the complexity of the task assumed by the contractor. This factor is specifically limited to the risk of contract costs. Thus, such risks on the part of the contractor as reputation, losing a commercial market, losing potential profits in other fields, or any risk on the part of the contracting activity, such as the risk of not acquiring an effective weapon, are not within the scope of this factor.

(2) The first and basic determination of the degree of cost responsibility assumed by the contractor is related to the sharing of total risk by contract cost by the Government and the contractor through the selection of contract type. The extremes are a cost-plus-fixed-fee contract, requiring only that the

contractor use his best efforts to perform a task, and a firm fixed-price contract for a complex item. A cost-plus-fixed-fee contract reflects a minimum assumption of cost responsibility, whereas a firm fixed-price contract reflects a complete assumption of cost responsibility.

(3) The second determination is that of the reliability of the cost estimates. Sound price negotiation requires well-defined contract objectives and reliable cost estimates. Prior production experience assists the contractor in preparing reliable cost estimates on new contracts for similar equipment. An excessive cost estimate reduces the possibility that the cost of performance will exceed the contract price, thereby reducing the contractor's assumption of contract cost risk.

(4) The third determination is that of the difficulty of the contractor's task. The contractor's task can be difficult or easy, regardless of the type of contract.

(5) Contractors are likely to assume greater cost risk only if contracting officers objectively analyze the risk incident to proposed contracts and are willing to compensate contractors for it. Generally, a cost-plus-fixed-fee contract will not justify a reward for risk in excess of 0.5 percent, nor will a firm fixed-price contract justify a reward of less than the minimum on the weighted guidelines. Where proper contract-type selection has been made, the reward for risk, by contract type, will usually fall into the following percentage ranges:

(i) type of contract and percentage ranges for profit objectives developed by using the manufacturing weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	
With Cost Incentives Only	1 to 2%
With Multiple Incentives	1.5 to 3%
Fixed-Price-Incentive	
With Cost Incentives Only	3 to 5%
With Multiple Incentives	4 to 6%
Prospective Price Redetermination	4 to 6%
Firm Fixed-Price	6 to 8%

(ii) type of contract and percentage ranges for profit objectives developed by using the research and development weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	
With Cost Incentives Only	1 to 2%
With Multiple Incentives	1.5 to 3%
Fixed-Price-Incentive	
With Cost Incentives Only	2 to 4%
With Multiple Incentives	3 to 5%
Prospective Price Redetermination	3 to 5%
Firm Fixed-Price	5 to 7%

(iii) type of contract and percentage ranges for profit objectives developed by using the service contract weighted guidelines method:

Cost-Plus-Fixed Fee	0 to 0.5%
Cost-Plus-Incentive Fee	1 to 2%
Fixed-Price-Incentive	2 to 3%
Firm Fixed-Price	3 to 4%

a. These ranges may not be appropriate for all acquisitions. For instance, a fixed-price-incentive contract that is closely priced with a low ceiling price and high incentive share may be tantamount to a firm fixed-price contract. In this situation, the contracting officer may determine that a basis exists for high confidence in the reasonableness of the estimate and that little opportunity exists for cost reduction without extraordinary efforts. On the other hand, a contract with a high ceiling and low incentive formula can be considered to contain cost-plus-incentive-fee contract features. In this situation, the contracting officer may determine that the Government is retaining much of the contract cost responsibility and that the risk assumed by the contractor is minimal. Similarly, if a cost-plus-incentive-fee contract includes an unlimited downward (negative) fee adjustment on cost control, it could be comparable to a fixed-price-incentive contract. In such a pricing environment, the contracting officer may determine that the Government has transferred a greater amount of cost responsibility to the contractor than is typical under a normal cost-plus-incentive-fee contract.

b. The contractor's subcontracting program may have a significant impact on the contractor's acceptance of risk under a contract form. It can cause risk to increase or decrease in terms of both cost and performance. This consideration shall be a part of the contracting officer's overall evaluation in selecting a factor to apply for cost risk. It may be determined, for instance, that the prime-contractor has effectively transferred real cost risk to a subcontractor and the contract cost risk evaluation, as a result, may be below the range that would otherwise apply for the contract type being proposed. This situation will be found to exist only in a few extraordinary situations under circumstances of (i) a follow-on production contract, in which a substantial portion of the total contract costs represents a single subcontract or a few subcontracts, (ii) the fullest incentive reward and penalty feature on cost performance having been passed by the prime contractor to the subcontractor. In an acquisition in which all of these circumstances are found to exist, a lower than usual profit weight may be applied to the aggregate of all recognized costs including the subcontract portion. The contract cost risk evaluation shall not be lowered, however, merely on the basis that a substantial portion of the contract costs represents subcontracts without any substantial transfer of contractor's risk, since this can result eventually in a lessening of the amount of work let on subcontracts.

c. In making a contract cost risk evaluation in an acquisition that involves definitization of a letter contract, unpriced change orders, and unpriced orders, under BOAs, consider the effect on total contract cost risk as a result of having partial performance before definitization. Under some circum-

3-808.6

THIS PAGE IS BEST QUALITY PRINTED
FROM GPO'S MASTERED TO BSA

stances it may be reasoned that the total amount of cost risk has been effectively reduced. Under other circumstances it may be apparent that the contractor's cost risk remained substantially unchanged. To be equitable, the determination of a profit weight for application to the total of all recognized costs, both those incurred and those yet to be expended, must be made with consideration to all attendant circumstances and not be just the portion of costs incurred, or percentage of work completed, prior to definitization.

d. Time and material, labor hour, and overhaul contracts priced on a time and material basis shall be considered to be cost-plus-fixed-fee contracts for the purpose of establishing a profit weight in the evaluation of the contractor's assumption of contract cost risk.

e. In determining the contract cost risk percentage under CONTRACTOR RISK in profit factors of the weighted guidelines provided in 3-808.4(a), it is appropriate to consider additional risks associated with foreign military sales (FMS). To be recognized, an additional cost risk factor shall be demonstrated by the contractor to be significant and over and above that normally present in DoD contracts for similar items. If an additional cost risk factor associated with FMS is recognized, the total profit under the CONTRACTOR RISK section (3-808.4(a)) shall not exceed the limits set forth in 3-808.6(b)(5) for different types of contracts. For example, when the manufacturing weighted guidelines method is used, the limitation will be 0.5 percent for CPFF contracts, 3 percent for CPIF contracts, 6 percent for FPI contracts and 8 percent for FFP contracts. The additional cost risk factor shall not apply to foreign military sales made from inventories or stocks nor to acquisitions made under DoD cooperative logistics support arrangements.

3-808.7 Facilities Capital Investment. This element relates to the consideration to be given in the profit objective in recognition of the investment risk associated with the facilities employed by the contractor. Sixteen to twenty percent of the net book value of facilities capital allocated to the contract is the normal range of weight for this profit factor. The key factors that the contracting officer shall consider in evaluating this risk are:

- (i) the overall cost effectiveness of the facilities employed;
- (ii) whether the facilities are general purpose or special purpose items;
- (iii) the age of the facilities;
- (iv) the undepreciated value of the facilities;
- (v) the relationship of the remaining writeoff life of the investment and the length of the program(s) or contract(s) on which the facilities are employed; and
- (vi) special contract provisions that reduce the contractor's risk of recovery of facilities capital investment (termination-protection clauses, multiyear cancellation ceilings, etc.).

To assist in evaluating new investment, the contracting officer should request the contractor to submit reasonable evidence that the new facilities are part of an approved investment plan and that achievable benefits to the Government will result from the investment. New industrial facilities and equipment shall receive maximum weight when they—

3-808.7

- (i) are to be acquired by the contractor primarily for defense business;
- (ii) have a long service life;
- (iii) have a limited economic life due to limited alternative uses; and
- (iv) reduce the total life cycle cost of the products produced for the Department of Defense.

To the extent that the new investment represents routine replacement of existing assets, a lesser weight shall be assigned.

3-808.8 *Special Factors.*

(a) *Productivity.*

(1) *General.* A key objective of the DoD profit policy is to reduce the cost of defense preparedness by incentivizing defense contractors' investment in modern cost-reducing facilities and other improvements in efficiency. To the extent that costs serve as the basis for pricing (both cost and profit), success in reducing costs can serve, in turn, to reduce profit dollars opportunity. For example, a fixed-price incentive-type contract is typically used for the first production contract of a major weapon system program. The incentive to increase productivity and reduce cost within one contract works against a contractor on follow-on production contracts because the reduced level of cost becomes a part of the basis for pricing subsequent contracts. In order to mitigate the loss of profit dollars opportunity that occurs when costs are reduced due to productivity gains, a special "Productivity Reward" may be included in the prenegotiation profit objective of a pending acquisition under certain circumstances.

(2) *Applicability Criteria.* The "Productivity Reward" may be applied when the following criteria are met:

- (i) The pending acquisition involves a follow-on production contract.
- (ii) Reliable actual cost data is available to establish a fair and reasonable cost baseline.
- (iii) Changes made in the configuration of the item being acquired are not of sufficient magnitude to invalidate price comparability.

(3) *Implementation Procedures.* The amount of productivity reward for a given contract is based on the estimated cost reduction that can be attributed to productivity gains. Set forth below are principles and procedures that apply to estimating cost reductions and calculating the productivity reward:

- (i) The contractor shall prepare and support the cost reduction estimate.
- (ii) The overall contract cost decrease shall be based on estimated decreases measured at the unit cost level.
- (iii) The lowest average unit cost (exclusive of profit) for a preceding production run shall serve as the unit cost baseline.
- (iv) A technique shall be employed to determine that portion of the cost decrease attributable to productivity gains as op-

ALL COPY PROCESSED TO 2025

posed to the effects of quantity differences between the base contract and the pending acquisition.

- (v) When the parties agree that the estimated overall contract cost decrease is materially affected by price level differences between the base period and the current point in time, an economic price adjustment may be applied to the estimate.
- (vi) The productivity reward shall be calculated by multiplying the contract cost decrease due to productivity gains by the base profit objective rate.
- (vii) The degree of review and validation of the data supporting the productivity reward calculation shall be commensurate with the materiality of this profit element in relation to the overall price objective.

There may be several methods advanced, by both contracting officers and contractors, to quantify productivity gains. Any technique may be acceptable, provided it takes into account equitably the principles and procedures listed above.

(b) *Independent Development.* Contractors who develop items that have potential military application without Government assistance are entitled to special profit consideration on those items as a special profit factor to be considered within the weighted guidelines in arriving at a profit objective. One to four percent of recognized cost is established as the normal range of value for this profit factor. The criteria for selection of the specific percentage shall be the importance of the development in advancing defense purposes, the demonstratable initiative in determining the need and application of the development, the extent of the contractor's cost risk, and whether the development cost was recovered directly or indirectly from Government sources.

(c) *Other Factors.* A composite percentage weight within the range of -5 percent to +5 percent of the basic profit objective may be assigned to other profit factors in arriving at the total profit objective. These other profit factors, which may apply to special circumstances or particular acquisitions, relate to contractor participation in the Government's Small Business, Small Disadvantaged Business, and Labor Surplus Programs, and to special situations not specifically set forth elsewhere in these guidelines. Participation that is rated as merely satisfactory shall be assigned a weight of zero, generally. Evidence of energetic support may justify a plus weight and poor support a negative weight. Special situations may be assigned either a plus or minus weight depending on the particular circumstances of the acquisition.

(1) *Small Business and Small Disadvantaged Business Participation.* The contractor's policies and procedures that energetically support Government small business and small disadvantaged business subcontracting programs, pursuant to 1-707 and 1-332, shall be given favorable consideration. Any unusual effort that the contractor displays in subcontracting with small business or small disadvantaged business concerns, particularly for development-type work likely to result in later production opportunities, and the overall effectiveness of the contractor in subcontracting with and furnishing assistance to such concerns shall be considered. Conversely, failure or

unwillingness on the part of the contractor to support Government small business or small disadvantaged business policies shall be viewed as evidence of poor performance for the purpose of establishing a profit objective.

(2) *Labor Surplus Area Participation.* A similar review and evaluation (as required in (1) above) shall be given to the contractor's policies and procedures supporting the Government's Labor Surplus Area Program, pursuant to 1-805.1. In particular, favorable consideration shall be given to a contractor who (i) makes a significant effort to help find jobs and provide training for the hardcore unemployed, or (ii) promotes maximum subcontractor utilization of certified eligible concerns, as defined in 1-801.1.

(3) *Energy Conservation.* Favorable consideration shall be given to the contractor's initiatives and accomplishments in the conservation of energy.

(4) *Special Situations.* Particular situations may justify use of a profit factor other than those specifically identified in these guidelines. These situations shall be identified and the reason(s) for their use documented in the records of price negotiation. Examples of such situations include contractor effort to exploit additional production cost-reduction opportunities or to improve or develop new product/manufacturing technologies to reduce production cost.

APPENDIX B
NAVAL POSTGRADUATE SCHOOL
MONTEREY, CALIFORNIA 93940

8 October 1980

Director of Procurement & Production
Headquarters,
U.S. Army Material Readiness Command
Redstone Arsenal, Alabama 35809

Dear Sir:

I am presently enrolled in the Naval Postgraduate School at Monterey, California where I am studying Acquisition and Contract Management. In partial completion of the requirements for graduation, I am researching and writing a thesis on "DOD's Profit Policy--Its Effectiveness, The Contracting Officer's View." During the course of my studies, I have found that alot has been written on the pros and cons of DOD's Profit Policy, but that most of it has been from the perspective of the businessman, policymakers, politicians and academicians. The objective of my research is to try and find out what the Contracting Officers, the policy implementers, the day to day users of the policy feel about its effectiveness. This information will be gathered by means of a survey that I am sending to all the major buying commands within the Department of Defense.

In order to achieve my objectives, I would appreciate it if you would distribute the enclosed surveys to the warranted contracting officers in your organization and encourage them to return it by the end of October. Your assistance in this endeavor will be greatly appreciated. Thank you very much.

Very respectfully

Thomas P. Anderson, IV
LT, SC, USN

DOD PROFIT POLICY SURVEY

In the course of preparing my thesis toward satisfying graduation requirements at the Naval Postgraduate School, I am researching the effectiveness of DOD's Profit Policy as stated in DAR 3-808 in incentivizing defense contractors to invest in new plant and equipment. My goal is to determine what DOD Contracting Officers perceive the policy's effectiveness to be. Also the responses will hopefully point toward any needed changes or improvements.

In order to determine the perceptions of Contracting Officers, it would be appreciated if you would take just a few minutes to fill out this short questionnaire and return it to me in the envelope provided. I am looking for your own thoughts and ideas. Any past experiences that you may wish to include in your responses will be appreciated. Please be candid and honest in your responses as the anonymity of respondents will be maintained.

I am planning to consolidate the data that you provide at the end of October and will be very grateful if you help me meet this deadline. Thank you for your cooperation.

Naval Postgraduate School
SMC 1951
Monterey, Ca. 93940

Very respectfully,



Thomas P. Anderson, IV
LT, SC, USN

BACKGROUND QUESTIONS

1. How many years experience do you have in your present position? _____
2. Do you have any related job experience in positions other than your present position? If so, what type of experience? (Optional)
3. What is the highest educational level you have achieved?
☐ High school or less ☐ Some Bachelor's work ☐ Bachelor's degree
☐ Some Master's work ☐ Master's degree ☐ More than a Master's degree
4. What is the average dollar value of the contracts you presently work with?
☐ Less than \$500,000 ☐ 500,000 to 1 million ☐ 1 to 25 million
☐ 25 to 50 million ☐ 50 to 100 million ☐ Greater than 100 million

POLICY QUESTIONS

5. Please list the following policies as to their priority within your organization? (One is the highest and five is the lowest)
☐ Competition ☐ Small and Disadvantaged Business ☐ Profit
☐ Standardization ☐ Component Break Out

6. How would you classify the guidance you have received on the use and implementation of profit policy as it relates to your every day interaction with the policy?

☐ Excellent ☐ Very helpful ☐ Helpful ☐ Weak ☐ Useless

7. Through what medium have you received most of your guidance on implementing profit policy? (List in numerical order--1 indicating the most)

☐ Directives ☐ Instructions ☐ Memos ☐ Policy Letters

☐ DAR ☐ Direct Supervisor ☐ Other (list) _____

8. Do you feel that the present DOD Profit Policy as stated in DAR Paragraphs 3-808.1, .7, and .8 is capable of motivating defense contractors to invest in new and more productive plant and equipment? ☐ Yes ☐ No

9. Do you feel that profit policy is the proper tool for incentivizing contractors to increase their investments in plant and equipment?

☐ Yes ☐ No Why?

10. What other Government, departmental, agency, etc., policies do you feel have a positive influence on the effectiveness of the profit policy and why?

11. What other policies do you feel have a negative influence on the effectiveness of DOD's Profit Policy and why?

12. In your experience has a contractor changed his capital expenditures because of the productivity reward or the facilities capital sections of the weighted guidelines? Why or why not?

13. Do you have any recommendations for improving the incentives mentioned in the previous question? If so, what?

14. If you have any other comments on the DOD's Profit Policy implementation or effectiveness, please use the space below or another sheet of paper.

APPENDIX C

ACTIVITIES RECEIVING THE QUESTIONNAIRE

NAVY

Naval Sea Systems Command
Washington, D.C. 20362

Naval Air Systems Command
Washington, D.C. 20361

Naval Electronics Systems Command
Washington, D.C. 20360

DEFENSE LOGISTICS AGENCY

Defense Electronics Supply Center
Dayton, Ohio 45444

Defense General Supply Center
Richmond, Virginia 23219

Defense Industrial Supply Center
Philadelphia, Pennsylvania 19111

Defense Construction Supply Center
Columbus, Ohio 43215

AIR FORCE

Headquarters Aeronautical Systems Division
Wright-Patterson AFB, Ohio 45433

Space and Missile Test Organization
Vandenberg AFB, California 93437

Space Division
Los Angeles AFS, California 90009

Headquarters Electronic Systems Division
Hanscom AFB, Massachusetts 01731

Armament Division
Eglin AFB, Florida 32542

Oklahoma City ALC
Tinker AFB, Oklahoma 73145

Sacramento ALC
McClellan AFB, California 95652

Warner Robins ALC
Robins AFB, Georgia 31098

San Antonio ALC
Kelly AFB, Texas 78241

Ogden ALC
Hill AFB, Utah 84406

ARMY

U.S. Army Missile Command
Redstone Arsenal, Alabama 35809

Headquarters U.S. Army Aviation, Research and
Development Command
St. Louis, Missouri 63166

U.S. Army Communications and Electronics Materiel
Readiness Command
Fort Monmouth, New Jersey 07703

U.S. Army Armament Materiel Readiness Command
Rock Island Arsenal, Illinois 61201

U.S. Army Troop Support and Aviation Readiness Command
St. Louis, Missouri 63120

U.S. Army Tank-Automotive Research and Development
Command
Warren, Michigan 48090

U.S. Army Tank-Automotive Materiel Readiness Command
Warren, Michigan 48090

U.S. Army Materiel Readiness Command
Redstone Arsenal, Alabama 35809

AD-A096 305

NAVAL POSTGRADUATE SCHOOL MONTEREY CA
DOD PROFIT POLICY. ITS EFFECTIVENESS. THE CONTRACTING OFFICER'S--ETC(U)
DEC 80 T P ANDERSON

F/G 5/1

UNCLASSIFIED

NL

2 of 2
AD-A
UNCLASSIFIED



END
DATE
FILMED
4-81
DTIC

LIST OF REFERENCES

1. American Management Association, Defense Marketing in the 60's, 1961.
2. Babione, D. R., "Contractor Investment in Defense Industry--Where Is It?", Defense Management Journal, v. 13, p. 9-15, April 1977.
3. Babione, D. R., "Profit '76 Revisited DOD Revamping Its Profit Policies for Defense Contractors," Defense Management Journal, v. 12, p. 41-16, October 1976.
4. Bacon, K. J., "Defense Department Reluctantly Plans to Have Contractors File Profit Reports," Wall Street Journal, p. 4, 5 September 1978.
5. Bicksler, J. and Hess, P. J., "A Note on the Profits and Riskiness of Defense Contractors," The Journal of Business, v. 49, p. 555-557, October 1976.
6. Bohi, D. R., "Profit Performance in the Defense Industry," Journal of Political Economy, v. 81, p. 721-728, May/June 1973.
7. Blair, R. J., Problems with the New Department of Defense Profit Policy, Master's Thesis, Air Force Institute of Technology, 1976.
8. Bureau of Demobilization, Industrial Mobilization for War: History of the War Production Board and Predecessor Agencies 1940-1945, v. 1, United States Government Printing Office, 1947.
9. Burns, A. E., "Profit Limitation: Regulated Industries and the Defense-Space Industries," Bell Journal of Economics and Management Science, p. 3-25, Spring 1972.
10. Clements, W. P., "Profits for Productivity," speech before the NCMA Washington Chapter Symposium, 1 October 1975.
11. Congressional Quarterly Weekly Report, v. 38, 2 February 1980.
12. Defense Management Issue Analysis Team #6a, DOD Profit Policy and Capital Investment, National Defense University, Washington, D.C., May 1980.

13. Department of Defense, Defense Acquisition Regulations, 1976 Edition.
14. Dewell, K. G., Government-Prime Contractor-Sub Contractor Relationships: An Analysis, Master's Thesis, Naval Postgraduate School, December 1979.
15. Fox, R. J., Arming America, How the U.S. Buys Weapons, Harvard University, 1974.
16. Gallup, G. H., A Guide to Public Opinion Polls, Princeton University Press, 1944.
17. Gansler, J. S., The Diminishing Economic and Strategic Viability of the U.S. Defense Industrial Base, Ph.D. Thesis, American University, 1978.
18. Goodhue, Lowell H., "Fair Profits from Defense Business," Harvard Business Review, p. 97-107, March-April 1972.
19. Graham, J., The Federal Government and Contract Profit Analysis: Background, Philosophy, Policy, and Practice, Paper prepared for a contract management research seminar at the Florida Institute of Technology, 6 June 1969.
20. Jacobs, J. L., "A Briefing on DOD Profit Policy Revisions Set for January Implementation," Contract Management, p. 10-12+, January 1980.
21. Kasputys, J. E., The Influence of Government Profit Policies on Contractor Management, Ph.D. Thesis, Harvard University, 1972.
22. Kaufman, R. F., The War Profiteers, The Bobbs Merrill Company, Inc., 1970.
23. Letzkus, W. C., "Facilities Investment and Contractor Profits," National Contract Management Journal, v. 11, p. 1-14, Winter 1977-78.
24. Livesay, W. E., "Capital Investment Incentive - A Method of Underwriting Large Defense Programs," National Contract Management Journal, v. 14, p. 31-34, Summer 1980.
25. Logistics Management Institute, "Study of Profit or Fee Policy," LMI Project 5B1, January 1963.
26. Marx, T. G., "Accounting Measures and Economic Analysis of Reasonable Profitability on Government Defense Contracts," Akron Business and Economic Review, v. 8, p. 7-15, Fall 1977.

27. Marx, T. G., "Legal Guidelines of Reasonable Profitability on Government Defense Contracts," Akron Business and Economic Review, v. 8, p. 11-14, Summer 1977.
28. Mayer, A. J., "Is America Strong Enough," Newsweek, v. XCVI, p. 48-67, 27 October 1980.
29. McCullough, J. L., Department of Defense Profit Policy: A Test of the New Approach, Florida Institute of Technology, June 1977.
30. Nash, R. C., Jr., and Cibinic, J., Jr., Federal Procurement Law, Volume 1, Contract Formation, 3d ed., The George Washington University, 1977.
31. Paulson, H. M., Jr., "DOD Profit on Capital Policy," National Contract Management Association Newsletter, p. 110-111, October 1972.
32. Peck, M. J., and Scherer, F. M., The Weapons Acquisition Process: An Economic Analysis, Harvard University, 1962.
33. "The Profit Puzzle in Procurement," Business Week, p. 44, 6 March 1971.
34. Runkle, J. R., An Assessment of Behavioral Influences on Defense Business Profitability, paper done at the Air University, Maxwell ABF, June 1980.
35. Shillito, B. J., "Some Thoughts on Profit," Contract Management, p. 13-14, October 1980.
36. Simonson, G. R., "Defense Profits Policy - A Critical Assessment," National Contract Management Journal, v. 14, p. 57-65, Summer 1980.
37. U.S. Congress, Joint Committee on Defense Production, Defense Industrial Base: DOD Profit 76 Study, Hearing before the Committee, 94th Cong. 2nd sess., 18 November 1976.
38. U.S. Department of Defense, Defense Procurement Circular 76-3, Office of the Assistant Secretary of Defense (Installations and Logistics), Washington, D.C., 1 September 1976.
39. U.S. Department of Defense, Defense Procurement Circular 76-23, Washington, D.C., 26 February 1980.

40. U.S. General Accounting Office, Report to Congress, "Defense Industry Profit Study," (B-159896), 17 March 1971.
41. U.S. General Accounting Office, Report to Congress, "Recent Changes in the Defense Department's Profit Policy--Intended Results not Achieved," PSAD 79-38, 8 March 1979.
42. Whelan, J. W. and Pasley, R. S., Cases and Materials on Federal Government Contracts, The Foundation Press, Inc., 1975.
43. Witze, C., "Declining Defense Profits - Government Economy or a National Security Risk," Air Force Magazine, p. 130, April 1970.
44. Wood, R. K., Myers, M. G., and McDonald, M. B., "A Uniform Profit Policy for Government Acquisition," Logistics Management Institute Task 77-15, Washington, D.C., December 1978.

INITIAL DISTRIBUTION LIST

	No. Copies
1. Defense Technical Information Center Cameron Station Alexandria, Virginia 22314	2
2. Library, Code 0142 Naval Postgraduate School Monterey, California 93940	2
3. Defense Logistics Studies Information Exchange U.S. Army Logistics Management Center Fort Lee, Virginia 23801	1
4. Department Chairman, Code 54 Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	1
5. Asst. Professor D. V. Lamm, Code 54Lt Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	5
6. Asst. Professor M. L. Sneiderman, Code 54Zz Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	1
7. Asst. Professor D. Boger, Code 54Bk Department of Administrative Sciences Naval Postgraduate School Monterey, California 93940	1
8. Lieutenant Thomas P. Anderson, IV, USN Naval Regional Contracting Office Box 50 FPO New York, NY 09521	1